REVENUE PROVISIONS IN PRESIDENT'S FISCAL YEAR 2000 BUDGET

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

MARCH 10, 1999

Serial 106–21

Printed for the use of the Committee on Ways and Means

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REVENUE PROVISIONS IN PRESIDENT'S FISCAL YEAR 2000 BUDGET

WEDNESDAY, MARCH 10, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 11:30 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisories announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
February 18, 1999
No. FC–7

Archer Announces Hearing on Revenue Provisions in President's Fiscal Year 2000 Budget

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on revenue provisions in President Clinton's fiscal year 2000 budget proposals. The hearing will take place on Wednesday, March 10, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from both the U.S. Department of the Treasury and public witnesses. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

On February 1, President Clinton submitted his fiscal year 2000 budget to the Congress. This budget submission contains numerous revenue provisions; some of these were included in previous budget submissions, but many are new. Among the new items in the budget are several general and specific provisions intended to address corporate tax shelters. The hearing will give the Committee the opportunity to consider carefully these revenue initiatives.

In announcing the hearing, Chairman Archer stated: "I am disappointed that the President provides no meaningful tax relief in his budget for Americans, caught in the tax trap, who are working more and paying even higher taxes. Instead, his budget contains 81 provisions to increase taxes by more than $82 billion over the next five years. At a time when the Federal Government is collecting more taxes than it needs, the President should not be asking the Congress to adopt proposals that would further increase the tax burden on the American people."

FOCUS OF THE HEARING:

The Committee will focus on the revenue proposals contained in President Clinton's fiscal year 2000 budget. With respect to the Administration's tax shelter proposals, the Committee invites additional or alternative suggestions to constrain inappropriate corporate tax sheltering activity without impeding legitimate business transactions.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Pete Davila at (202) 225–1721 no later than the close of business, Friday, February 26, 1999. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee on staff at (202) 225–1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record, in accordance with House Rules.

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, of their prepared statement for review by Members prior to the hearing. Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than March 8, 1999. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, March 24, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

***** NOTICE—Change in Time *****

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE | CONTACT: (202) 225–1721
March 5, 1999
No. FC–7-Revised

Time Change for Full Committee Hearing on Wednesday, March 10, 1999, on Revenue Provisions in President's Fiscal Year 2000 Budget

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on revenue provisions in President Clinton's fiscal year 2000 budget proposals, previously scheduled for Wednesday, March 10, 1999, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, will begin instead at 11:30 a.m.

All other details for the hearing remain the same. (See full Committee press release No. FC–7, dated February 18, 1999.)

Chairman ARCHER. The Committee will come to order.

This afternoon's hearing has been called to review the revenue proposals contained in President Clinton's budget for the fiscal year beginning October 1. A hearty welcome to our guests and to Secretary Lubick. I thank all of you for joining us.

According to the nonpartisan Joint Committee on Taxation, the White House proposes an $89 billion tax increase over the next 10 years. The budget contains 47 tax reduction proposals totaling $82 billion, but it also includes 75 tax hikes, which raise $172 billion. The combination of the two is a net $89 billion tax hike.

With a multitrillion dollar surplus projected as far as the eye can see, it is hard to understand why anyone would want to raise taxes on any entity or individual in this country. As for the proposed tax cuts, they most definitely complicate the Code. If you are a nonsmoker who drives a fuel-efficient car from your rooftop solar-equipped home to your specialized small business investment company where you work, you get a tax cut.

However, given how difficult the tax forms are to fill out, I'm not sure that taxpayers will welcome those ideas. On the other hand, accountants, tax lawyers, and social engineers will be most happy, I'm sure.

On the tax side, where they are raised, the budget contains dozens of tax-hike repeats which have already been met with the massive bipartisan opposition of most Ways and Means Members. In fact, of the 75 hikes in the budget, 34 provisions worth $132 billion are old news.

Let's not go down that road again.

There are, however, some ideas that we will explore. The area of corporate tax shelters is one field that merits review. I have already announced my support for a school construction initiative. I intend to pursue other areas on which we can build common ground.

On balance, however, this budget would make April 15th a bigger headache for the taxpayers. Higher taxes, bigger headaches, more complexity. I intend to pursue a different course to lower taxes, to close unintended loopholes and abuses and anachronisms on the way to a simpler and a fairer code.

And I look forward to working with all Members of the Committee to get this job done.

[The opening statement follows:]

Statement of Hon. Bill Archer, a Representative in Congress from the State of Texas

Good morning.

Today's hearing has been called to review the revenue proposals contained in the President Clinton's budget for the fiscal year beginning October 1st, a little less than seven months away.

Welcome to our guests and to Secretary Lubick. Thank you for joining us.

According to the non-partisan Joint Committee on Taxation, the White House proposes an $89 billion tax increase over the next ten years. The budget contains forty-seven tax reduction proposals worth $82.1 billion, but it also includes seventy-five tax hikes which raise $171.8 billion. The combination of the two is the $89 billion tax hike.

With a multi-trillion dollar surplus projected as far as the eye can see, it's hard to understand why anybody would want to raise taxes on *anyone*.

As for the proposed tax *cuts*, they sure complicate the code. If you're a non-smoker, who drives a fuel-efficient car from your rooftop solar-equipped home to your specialized small business investment company where you work, you get a tax cut. However, given how difficult the tax forms are to fill out, I'm not sure that taxpayers will welcome these ideas. On the other hand, accountants, tax lawyers, and social engineers will find much to approve.

On the tax hike side, the budget contains dozens of tax hike repeats which have already met with the massive bipartisan opposition of most Ways and Means members. In fact, of the seventy-five tax hikes in the budget, 34 provisions worth $132 billion are old news. Let's not go down that road again.

There are, however, some ideas we will explore. The area of corporate tax shelters is one field which merits review. I have already announced my support for a school construction initiative. I intend to pursue other areas on which we can build common ground.

On balance however, this budget would make April 15th a bigger headache for the taxpayers. Higher taxes, bigger headaches, more complexity...I intend to pursue a different course to lower taxes, to close legitimate loopholes and anachronisms, on the way to a simpler, fairer code.

I look forward to working with all Members of the Committee to get the job done.

Chairman ARCHER. I yield to the other gentleman from Texas on the Committee for any statement he might like to make in behalf of the Minority.

Mr. DOGGETT. Thank you, Mr. Chairman. I am ready to move onto the hearing.

Chairman ARCHER. All right. We will commence then with our first witness, who is one of our colleagues, our friend and Member Bob Etheridge from North Carolina. Congressman Etheridge, we are happy to have you before us. We would encourage you to limit your verbal presentation to 5 minutes, and without objection, your entire printed statement will be inserted in the record.

So you may proceed.

STATEMENT OF HON. BOB ETHERIDGE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. ETHERIDGE. Thank you, Mr. Chairman. And I want to thank you and Ranking Member Rangel and the other Members of the Committee for allowing me this opportunity this afternoon. I do appreciate your courtesies of giving me the opportunity to present my views on the revenue provisions of the President's proposal fiscal year 2000 budget. And as you have just said, I understand you are going to adhere to the 5-minute rule, and I am going to try stick to it and move very quickly.

So I am going to focus my portion of the testimony this afternoon on the President's revenue proposals regarding school construction and modernization. And it is an issue that at the same time is near and dear to my heart and certainly is important to my district in North Carolina because, as you know, prior to my election to the people's House, I had served 8 years, which is two terms, as the elected State superintendent in my State. Prior to that I had the distinct privilege of spending 10 years in the State House, where I chaired the appropriations Committee for 4 years. And prior to that, I was a county commissioner for 4 years, for 2 years of which I had been chair.

So throughout my political career, I have been involved in this issue of building schools and helping improve the quality of education for all of our children. And it is important to all of us.

Across America today, there are 53 million children attending school. Too many of these children are not being educated in the kind of quality, well-equipped facilities where discipline and order foster academic achievement.

For many years, our Nation's school children have gone to classes in trailers, in closets, overstuffed and rundown classrooms. The nonpartisan General Accounting Office has determined that there exists somewhere in the neighborhood of $112 billion in school construction needs in America right now. That does not measure the impact of enrollment growth.

We now have more children in our public schools than at any time in our Nation's history, including the height of the baby boom. As the children of the baby boomers themselves now begin to reach school age, the resulting baby-boom echo is putting tremendous pressure on our educational facilities in every State and in every community.

That is why the administration's proposal, sponsored in the House by my friend Mr. Rangel, is critically needed as a policy innovation for the dawn of the new millennium. The Rangel School Modernization Act will utilize the resources of the Federal Government to leverage investments that localities across the country are struggling to make to modernize their school infrastructure.

The Rangel bill, of which I am a strong supporter and an original cosponsor, will provide Federal tax credits to bond holders to finance approximately $22 billion in school construction bonds across America. The bonds under this bill will be allocated among the States on an income-formula basis and to the largest school districts whose aging infrastructure presents a serious need for school modernization.

In my district, the problem is somewhat different. Communities throughout the Second District in North Carolina are growing by leaps and bounds, and our schools are bursting at the seams. Local community leaders are scrambling to find creative solutions to the problem of explosive growth, and they need our help, and they need it now.

For example, just this past week, I visited Wake Forest-Rolesville High School in Wake County, which is one of the larger counties in my district. There teachers and students are struggling mightily against the constraints of overcrowding to achieve the shared goal of quality education. But in Wake County, we are adding anywhere from 3,500 to 4,500 students per year to a school system that is really hurting.

The county has grown by more than 33.8 percent since 1990, and counties throughout my district have grown by anywhere from 20 to 30 percent. These localities simply do not have the means to build schools fast enough to have first-class facilities.

To complement the Rangel bill, I have written and introduced H.R. 996, the Etheridge School Construction Act, which will provide tax credits to leverage $7.2 billion in school construction bonds for localities suffering from the ill effects of burdensome growth.

I am proud that this bill has 67 cosponsors, many of whom, Mr. Chairman, are on this Committee. And I invite other Members to join me.

For example, Texas qualifies for $840 million under H.R. 996, and I ask permission to submit the entire list for the record.

Chairman ARCHER. Without objection, so ordered.

Mr. ETHERIDGE. In conclusion, there is no reason why school construction should be a partisan issue. Indeed, I would argue that our children's future is the last thing that should be left to the mercy of partisan politics.

Earlier this century, the men and women who have been called the greatest generation came home from World War II and put their shoulders to the wheel, built schools, gave us the kind of economy we are now enjoying. We have the opportunity, Mr. Chairman, to do the same.

Now we have a chance, as we move to the 21st century and emerge from the cold war to make the new millennium a millennium of education for all children.

[The prepared statement and attachment follow:]

Statement of Hon. Bob Etheridge, a Representative in Congress from the State of North Carolina

Thank you Mr. Chairman, Ranking Democrat, my good friend Charlie Rangel, and all the committee Members for allowing me to testify here this morning.

I appreciate your courtesy of giving me the opportunity to present my views on the revenue provisions of the President's proposed Fiscal Year 2000 budget. I understand the five-minute rule will be strictly enforced, and therefore I would like to focus my testimony on the President's revenue proposal regarding school construction and modernization. It is an issue that is at the same time near and dear to my heart and absolutely critical to the Congressional District I represent.

Prior to my election to the People's House in 1996, I served eight years as the two-term North Carolina Superintendent of public schools, which is a statewide elected position in my state. Earlier, I had served in the state legislature as the chairman of the Appropriations Committee and on the county commission in my home of Harnett County. So I have a rather unique perspective as someone who has struggled with this issue at each of the different levels of government. Throughout my years in public office, building schools and improving education for our children has been my life's work.

Across the country today, there are 53 million children attending school in America's classrooms. Far too many of these children are not being educated in modern, well-equipped facilities where discipline and order foster academic achievement. For many of our nation's schoolchildren, class is being taught in a trailer or in a closet or in an overstuffed or run-down classroom. The nonpartisan Government Accounting Office has determined there exists nationwide $112 billion in school construction needs just to accommodate today's enrollment levels.

We now have more children in our public schools than at any time in our nation's history, including the height of the Baby Boom. As the children of the Baby Boomers themselves now begin to reach school age, the resulting "Baby Boom Echo" is putting tremendous pressure on our educational facilities.

This is why the Administration's proposal, sponsored in the House by my good friend Mr. Rangel, is a critically needed policy innovation for the dawn of the next century. The Rangel School Modernization Act will utilize the resources of the federal government to leverage investments that localities across the country are struggling to make to modernize their school infrastructure. The Rangel bill, of which I am a strong supporter and an original cosponsor, will provide federal tax credits to bond holders to finance $22 billion in school construction bonds throughout the country. The bonds under the Rangel bill will be allocated among the states on an income-based formula and to the largest school districts where aging infrastructure presents a serious need for school modernization.

In my district, the problem is somewhat different. Communities throughout the Second Congressional District are growing by leaps and bounds, and our schools are bursting at the seams. Local community leaders a scrambling to find creative solutions to the problem of explosive growth, and they need our help.

For example, earlier this week, I visited Wake Forest-Rolesville High School in Wake County in my district. There the teachers and students are struggling mightily against the constraints of overcrowding to achieve the shared goal of quality education. But in Wake County, we are adding 3500 to 4500 students per year to the school system. The county has grown by more than 29.4 percent since 1990, and counties throughout my district have experienced growth of 20 to 30 percent. These localities simply do not have the means to build the schools fast enough to provide this generation of schoolchildren a first-class education.

To complement the Rangel bill, I have written and introduced H.R. 996, the Etheridge School Construction Act, which will provide tax credits for $7.2 billion in school construction bonds for localities suffering the ill effects of boundless growth. I am proud to have Mr. Rangel and a number of my colleagues from this committee among the bill's 67 cosponsors, and I invite all the Members of the committee to sign on to H.R. 996. I have here a list that may interest you. These are the allocation amounts of what the individual states would get from my bill. For example, Texas qualifies for $840 million under H.R. 996. I ask permission to submit the entire list for the record.

In conclusion, there is no reason why school construction should be a partisan issue. Indeed, I would argue that our children's future is the last thing that should be left to the mercy of partisan politics. Earlier this century, the men and women who have been called "The Greatest Generation," resolved after winning World War II to invest in children and in the education of those children. That collective decision ushered in an era of economic prosperity, relative international peace and human progress that is unrivaled in the history of God's creation. We are the direct beneficiaries of that foresight, commitment and investment. As we emerge from the Cold War and enter a new millenium, I challenge this committee and this Congress to exercise the same patriotic devotion to our duty to provide for stronger future generations by coming together across party lines to pass common sense, visionary legislation like the Rangel School Modernization Act and the Etheridge School Construction Act.

Thank you, Mr. Chairman. I would be happy to answer any questions.

Congress of the United States
House of Representatives
Washington, DC 20515

February 24, 1999

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, DC 20515

The Honorable Charles Rangel
Ranking Member
Committee on Ways and Means
2354 Rayburn HOB
Washington, DC 20515

Dear Gentlemen:

We are concerned about a proposal included in the President's budget which would impose a tax on the investment income of associations exempt from tax under section 501 (c)(6) of the Internal Revenue Code.

Under the Administration's plan, the first $10,000 that an association earns from interest, dividends, capital gains, rents and royalties would not be taxed. However, all income earned over $10, 000 would be subject to the unrelated business income tax (UBIT).

Contrary to assertions made by the Administration, this proposal will effect thousands of small and mid-sized trade associations and professional societies exempt under 501(c)(6). According to the American Society of Association Executives's *Operating Ratio Report*, most associations with annual operating budgets of as low as $200,000 or more will be taxed on the income they receive from interest, dividends, capital gains, rents and royalties, under this tax. As many as 70,000 associations nationwide could be effected by this proposal.

Associations rely on this targeted income to carry out exempt-status related activities such as training, standard-setting, as well as providing statistical data and community services. Without associations performing these activities, the government would be forced to step in.

We ask that you please oppose this proposal that would place a tremendous tax burden on 501(c)(6) trade and professional associations.

Sincerely,

Phil English

Wes Watkins

Jim McCrery

Sam Johnson

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Chairman ARCHER. Thank you, Congressman Etheridge. Are there any questions for Congressman Etheridge? Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. And Mr. Etheridge, I welcome you to the Committee and glad you are here today.

Mr. ETHERIDGE. Thank you, Mr. Weller.

Mr. WELLER. Also want to point out, of course, you are talking today of course about school construction, and that is not really a partisan issue, as you point out. Both Chairman Archer and a number of Republicans have initiated school construction initiatives.

I know Representative Dunn and I have a tax simplification package, and we set aside $3 billion for school construction in our package. So I think clearly there is a bipartisan agreement that we want to do something. And, of course, the mechanics of doing that will be part of the process this year.

I think I would also like to point, as you note, education is important. And this Committee has made education pretty important here. We provided this year around April 15th there will be hundreds of thousands, if not millions, of Americans who will be taking advantage of the student loan interest deduction, a thousand-dollar deduction, that they will have thanks to this Committee, which enacted in the last couple of years.

And also education savings accounts for those who want to save for their children. There is more we need to do but——

You know, the issue today before this Committee is the over $170 billion in tax increases that the administration has proposed. And from your point of view, of course, the administration has proposed, I think, about $176 billion in tax hikes as part of their budget to pay for school construction. And there are other initiatives they discuss in the budget.

And I was wondering, what are your thoughts about the $176 billion in tax hikes that are in the administration's budget? Do you support those?

Mr. ETHERIDGE. Well, let me say I appreciate what this Committee has done. What you did last year, and what we all voted on to make education available for children who go to the universities because that is important.

Today, I am talking about those who want to get their start and make sure they show up at a school in a quality environment to learn because there are communities, even though they have certain resources, and they are taxed to the extent and in many cases they can't meet those needs. So I think we have a chance, at the Federal level now, to form a partnership, not unlike what we have done in so many other areas when we have the resources to do it.

The whole issue of tax increases and tax reductions are issues that we all have to come together and work and jointly decide whether or not they fit our priorities.

But I happen to believe the issue of opportunities for children are opportunities we have a chance to claim and deal with.

Mr. WELLER. Reclaiming my time, Representative. I think we agree. As I stated earlier, education is a priority, and in the administration's budget they propose $176 billion in tax increases, new taxes, on products important to your State and others. And I was just wondering, do you support—can you pick out one or two you think to be appropriate pay-fors to pay for the administration's school construction budget, something you think is an appropriate offset, something you would recommend.

Mr. ETHERIDGE. I have listed offsets in the proposal, Mr. Weller, that I laid out. There are definite proposals in there. There is one tax that I will not support, and I have already made public that. And that is another increase in the cigarette tax because that has a definite impact directly on my district.

Mr. WELLER. That is about a third of the President's tax hike.

Mr. ETHERIDGE. Not sure what that number is.

Mr. WELLER. The President also proposes as part of his pay-fors for his budget, about $9 billion in Medicare cuts to our local hospitals and $140 million in new taxes on our health-care providers. Do you feel those are appropriate pay-fors for a school construction initiative?

Mr. ETHERIDGE. Well, I didn't list any of those, I would say, in my proposal. Those proposals, they will have to be decided before any Committee. But the ones I laid out have nothing to do with Medicare and Medicare issues.

Mr. WELLER. So then you oppose the President's cuts in Medicare reimbursements to hospitals and oppose the administration's tax increase.

Mr. ETHERIDGE. And I can assure you, my hospitals are not happy with it either.

Mr. WELLER. All right. Well thank you, Representative.

Chairman ARCHER. If there are no further questions for Congressman Etheridge, we thank you for your appearance and for your presentation.

Mr. ETHERIDGE. Thank you, sir.

Chairman ARCHER. Our next witness is Assistant Secretary of the Treasury, Hon. Don Lubick, who is no stranger to our Committee. We are happy to have you with us today, and pleased to receive your verbal testimony. Without objection, your entire printed statement, will be inserted in the record.

Welcome, you may proceed.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY, TAX POLICY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY HON. JONATHAN TALISMAN, DEPUTY ASSISTANT SECRETARY, TAX POLICY

Mr. LUBICK. Thank you, Mr. Chairman. I appreciate as usual the——

Chairman ARCHER. Mr. Lubick, if I may, I should have also introduced and welcomed Jonathan Talisman, who is the Deputy Assistant Secretary for Tax Policy with the Treasury. We are happy to have you with us today too.

Mr. TALISMAN. Thank you, Mr. Chairman.

Chairman ARCHER. All right, Mr. Lubick.

Mr. LUBICK. As you have noted, Mr. Chairman, there is a lot of baggage that we are carrying. So it takes two of us. [Laughter.]

I always appreciate the rather kind treatment that I get here, even though I know occasionally you may disagree with something that I advocate. So appreciate that as well. And it goes for all the Members of the Committee.

I would like to address today the revenue provisions included in the President's Fiscal 2000 budget.

The Nation has moved from an era of large annual budget deficits to an era of budget surpluses, which are projected to continue for many, many years. This has resulted from the fiscal policy of the last 6 years, the economy it helped produce, and the ongoing interaction between the two.

Rather than facing an annual requirement to reduce the deficit, we now have before us the opportunity to face the serious challenges for generations to come by making wise policy choices. These challenges lie primarily in the area of the economic and fiscal pressures created by the retirement baby-boom generation. Meeting those challenges is exactly what the President's budget does.

The core of the budget is fiscal discipline and thereby increased national savings in order to promote continuing economic growth and retirement security in the years ahead.

The President's proposal is to commit 62 percent of the unified surplus for the next 15 years to Social Security. This is an infusion of $2.76 trillion to the trust fund, in addition to the $2.7 trillion of forecast off-budget surplus generated by payroll taxes in excess of receipts for the next 15 years, which would go to Social Security anyway.

The infusion, including increased rates of return from investing about 20 percent of the 62 percent of the unified surplus in equities, will extend the predicted period of solvency for the trust fund from 2032 to 2055. The remaining 20 years to reach 75 years of solvency will require tough decisions to be made jointly by the President and Congress.

An additional 15 percent of the surplus would be allocated to Medicare, and the President also proposes to devote 12 percent of the surplus to a program to encourage saving through USA Accounts. The majority of workers would receive an automatic contribution, and in addition, those who make voluntary contributions could receive a matching contribution to their USA Account.

The matching contribution would be more progressive than current tax subsidies for retirement savings, helping most the workers who most need to increase retirement savings.

By creating a retirement savings program for working Americans with individual and government contributions, all Americans will become savers and enjoy a more financially secure retirement.

The remaining 11 percent would be allocated to other priorities, including defense funding.

Finally, the budget insists that none of the surpluses be used at all until we have put Social Security on a sound financial footing for the long term.

I would like to address primarily today the package of about $34 billion in targeted tax reductions, which I would like to summarize briefly. They include increased funding for education, including tax credit bond programs totaling $25 billion to spur State and local government investment in elementary and secondary schools, expansion of the current law incentive for employer-provided educational assistance and a number of other items.

There are measures to make child care affordable by expanding the current child- and dependent-care credit and by providing a new employer credit to promote employee child care.

There are provisions to provide tax relief for individuals with long-term care needs or those who care for others with such needs, and to workers with disabilities. There are measures to promote health insurance coverage for employees of small business. There are incentives to promote the livability and revitalization of urban and rural communities, a tax credit to attract new capital to businesses located in low-income communities—expansion of the current law—low-income housing credit, and $3.6 billion in tax incentives to promote energy efficiency and reduce greenhouse gases.

There are several provisions to expand and simplify and increase the portability of retirement savings mechanisms. We have been in discussions with your Members, Congressmen Portman and Cardin, to deal with that problem.

We have proposed the extension of a recently enacted provision that prevents the nonrefundable tax credits, such as the education credit and the child credits, from being affected by the alternative minimum tax. I know that is a problem you concerned yourself with much recently.

And we proposed extenders of several tax provisions, such as the R&D tax credit, the work opportunity and welfare-to-work credits and the brownfields expensing program.

And there are also some provisions that would simplify the administration of the tax laws.

Mr. Chairman, sound fiscal policy demands that these proposals be fully funded, so the President's budget includes a package of revenue offsets that would fully offset our targeted tax incentives. Our revenue offsets would curtail corporate tax shelters and close loopholes in the tax law in the areas of financial products, corporate taxes, pass-through entities, tax accounting, cost recovery, insurance to exempt organizations, State and gift taxation, and a number of others.

Let me focus for a moment on proposals in our package that we believe will curtail significantly the development, marketing, and purchase of products designed to produce a substantial reduction in a corporation's tax liability.

The administration believes that there has been an increase in the use of corporate tax shelters and is concerned about this proliferation for several reasons. Corporate tax shelters reduce the corporate tax base. Moreover, they erode the integrity of the tax system as a whole. The view that large, well-advised corporations can and do avoid their legal tax liabilities by engaging in transactions unavailable to most other taxpayers may lead to a perception of unfairness and if unabated, may lead to a decrease in voluntary compliance.

Finally, the significant resources used to create, implement, and defend complex sheltering transactions are better used in more productive activities.

To date, most attacks on corporate tax shelters have been targeted at specific transactions and have incurred on an ad hoc, after-the-fact basis through legislative proposals, administrative guidance, and litigation.

At the Treasury Department, a number of actions have been taken to address corporate tax shelters. We have made legislative proposals aimed at corporate-owned life insurance, which awaits action by the Congress, section 357(c) abuses, which has been advanced in both chambers, and liquidating REITs, real estate investment trusts, which were enacted last year.

On the regulatory front, we have issued guidance such as the notice on step-down preferred, fast-paced, slow-pay transactions, and at litigation, we have won two important cases, *ACM*, and *ASA*.

But we often hear that we are only hitting the tip of the iceberg.

Addressing corporate tax shelters on a transaction-by-transaction ad hoc basis raises certain concerns. First, it is not possible to identify and address all current and future sheltering transactions. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions, the treatment of which is less specified.

Second, legislating on a piecemeal basis further complicates the Code, and seemingly calls into question the viability of common-law tax doctrines such as sham transaction, business purpose, economic substance, and substance over form.

Finally, using a transactional legislative approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market in the belief that any reactive legislation would be applied only on a prospective basis.

Mr. Chairman, we are gratified by recent statements that you have made supporting the need to address this problem. I won't go further by saying you have committed to anything in particular, but we are very pleased that you recognize that there is a problem to be addressed. We also want to thank the Members of this Committee for addressing specific corporate tax shelters that we or others have brought to their attention.

In addition, we are pleased that numerous tax practitioners and representatives even of Fortune 500 companies have spoken to us expressing their support for taking action. The administration, therefore, proposes several remedies to curb the growth of corporate shelters.

First, we propose more general remedies to deter corporations from entering into any sheltering transactions. These proposals would disallow any tax benefit created in a corporate tax shelter and would address common characteristics found in corporate tax shelters.

In addition, we propose specific remedies for certain transactions that we have already identified as being used to shelter improperly corporate income from Federal taxation. Also, all the parties to a structured transaction under our proposals, would have an incentive to assure that the transaction comports with established principles.

The Treasury Department recognizes that this more general approach to corporate tax shelters raises certain concerns. Applying various substantive and procedural rules to a corporate tax shelter for a tax-avoidance transaction requires definitions of such terms. As described in greater detail in our written testimony, the administration's proposals define these terms.

Critics of the proposals have suggested that these definitions are too broad or may create too much uncertainty and thus may inhibit otherwise legitimate transactions. The Treasury Department does not intend to affect any legitimate transaction. Let me state, however, that the definition we have proposed is similar to existing articulations of various judicial doctrines and may be viewed as largely enforcing the judicially created concept of economic substance that obtains in under current law.

The definition of corporate tax shelter, as used in our proposals, is narrower and, therefore, less uncertain than other definitions and formulations, which are part of our present legal treatment used in the Code and judicial interpretations of its provisions. We strike no new ground in defining the nature of tax shelters.

Taxpayers and practitioners have lived with the concepts our definitions embody, as they have been enunciated by the courts since the twenties. A measure of uncertainty is not only inevitable but perhaps desirable to prevent over-aggressive tax-avoidance scheming.

We ask practitioners to come forward with examples of legitimate tax planning that would be jeopardized by our definition.

Mr. Chairman, Members of the Committee, we will respond and work with this Committee to refine our definition in a manner that will protect from penalty any legitimate, normal, course-of-business transactions. I also want to mention that our budget contains a number of provisions that would close loopholes in the Code. They have great merit. They are discussed fully in my prepared remarks, which I appreciate your including in the record.

In conclusion, Mr. Chairman and Members of the Committee, the administration looks forward to working with you as you examine our proposals. We hope that you reach the conclusion that they are all meritorious, and that this Committee will approve them.

Mr. Talisman and I stand at the ready to attempt to answer any questions you may have.

[The prepared statement follows:]

Statement of Hon. Donald C. Lubick, Assistant Secretary, Tax Policy, U.S. Department of the Treasury

Mr. Chairman, Mr. Rangel, and Members of this committee, it is a pleasure to speak with you today about the President's FY 2000 budget.

The nation has moved from an era of large annual budget deficits to an era of budget surpluses for many years to come. This has resulted from the fiscal policy of the last six years, the economy it helped produce, and the ongoing interaction between the two. Rather than facing an annual requirement to reduce the deficit, we now have before us the opportunity to face the serious challenges for generations to come by making wise policy choices. These challenges lie primarily in the area of the economic and fiscal pressures created by the retirement of the baby boom generation. Meeting those challenges is exactly what the President's budget does. The core of this budget is fiscal discipline, and thereby increased national savings, in order to promote continuing economic growth and retirement security in the years ahead.

In 1992, the deficit reached a record of $290 billion, the Federal debt had quadrupled during the preceding twelve years, and both the deficit and debt were projected to rise substantially. The deficit binge has left us with publicly held debt of $3.7 trillion, and an annual debt service requirement that amounts to 15 percent of the budget. Now however, for the next 15 years, OMB forecasts cumulative unified surpluses of over $4.85 trillion.

It is important to note that transformation from deficits to surpluses has come about concurrent with tax burdens on typical working families being at record lows for recent decades. For a family of four with a median income, the federal income and payroll tax burden is at its lowest level in 21 years, in part because of the child tax credit enacted in the 1997 balanced budget plan. For a family of four with half the median income, the income and payroll tax burden is at its lowest level in 31 years, in part because of the 1993 expansion of the Earned Income Tax Credit for fifteen million families as well as the 1997 enactment of the child tax credit. And for a family of four with double the median income, the federal income tax burden is at its lowest level since 1973. While overall tax revenues have risen as a percentage of GDP, that is in part because higher income individuals have had large increases in incomes, resulting from, among other things, bonuses based on high stock prices and increased realizations of capital gains, and in part because of increased corporate earnings.

The President's proposal is to commit 62 percent of the unified surplus for the next 15 years to Social Security. This is an infusion of $2.8 trillion to the trust fund in addition to the $2.7 trillion of forecast off-budget surpluses generated by payroll taxes in excess of benefit payments. This infusion, including increased rates of return from investing one-fifth of the 62 percent of the unified surplus in equities, will push back the date of trust fund exhaustion from 2032 to 2055. Closing the remaining gap and thus assuring solvency over 75 years will require tough decisions to be made jointly by the President and Congress.

An additional 15 percent of the surplus would be allocated to Medicare. The President also proposes to devote 12 percent of the unified surplus to establishing a new system of Universal Savings Accounts. These accounts would provide a tax credit to millions of American workers to help them save for their retirement. A majority of workers could receive an automatic contribution. In addition, those who make voluntary contributions could receive a matching contribution to their USA account. The matching contribution would be more progressive than current tax subsidies for retirement savings—helping most the workers who most need to increase retirement savings. By creating a retirement savings program for working Americans with individual and government contributions, all Americans will become savers and enjoy a more financially secure retirement.

The remaining 11 percent would be allocated to other priorities, including increased defense spending. Finally, the budget insists that none of the surpluses be used at all until we have put Social Security on sound financial footing for the long-term.

When President Clinton was elected, publicly held debt equaled 50 percent of GDP. As a result of the President's plan, by 2014, publicly held debt will decline to about 7 percent of GDP. This reduction in debt will have three effects. First, the government will not have to refinance as much federal debt and thereby will consume less of national savings, thus making capital more readily available to the private sector. That, in turn, will reduce interest rates and increase confidence in the economy, increasing economic growth, job creation and standards of living. Second, debt service costs will decline dramatically. When the President came into office debt service costs of the federal government in 2014 were projected to constitute 27 percent of the federal budget. Under the President's proposal, and because of the progress we have made to date, we estimate the debt service costs will be 2 percent of the federal budget in 2014. Third, the decrease in debt means the federal government will have a greatly improved capacity to access external capital should the need arise.

This is not the time, with the economy running so well, for major tax cuts that are not offset by other measures. Public debt reduction is an opportunity that we should not squander, and it will reap broader and more permanent economic prosperity than any tax cut could. Public debt reduction has many of the economic effects of a tax cut, but maintains the fiscal discipline necessary to meet future challenges. It is the only responsible course to take.

Targeted incentives

Thus, the President's Budget also proposes a fully funded package of about $34 billion in targeted tax reductions, including provisions to rebuild the nation's schools, make child and health care more affordable, revitalize communities, provide incentives for energy efficiency, promote retirement savings, provide for tax simplification, and extend expiring provisions.

More specifically, to enhance productivity and maintain our country's competitive position in the years ahead, and to provide relief for working families, the Administration proposes:

- increased funding for education, including tax credit bond programs totaling $25 billion to spur State and local government investment in elementary and secondary schools, expansion of the current-law tax incentive for employer-provided educational assistance, simplification and expansion of the deduction allowed for student loan interest payments, tax-free treatment for certain education awards, and a tax credit for certain workplace literacy and basic education programs;

- measures to make child care more affordable, by expanding the current-law child and dependent care tax credit and by providing a new employer credit to promote employee child care;
- providing tax relief (in the form of a $1,000 credit) to individuals with long-term care needs, or who care for others with such needs, and to workers with disabilities;
- measures to promote health insurance coverage for employees of small businesses;
- incentives to promote the livability and revitalization of urban and rural communities, including a tax credit bond program totaling $9.5 billion to help States and local governments finance environmental projects, a tax credit to attract new capital to businesses located in low-income communities, expansion of the current-law low-income housing tax credit program, and $3.6 billion in tax incentives to promote energy efficiency and reduce greenhouse gases;
- several provisions to expand, simplify, and increase the portability of retirement savings mechanisms, and to make it easier for individuals to save for retirement on their own; and
- extension of a recently enacted provision that allows individuals to claim nonrefundable tax credits—such as the education credits and the $500 child credit—without being affected by the alternative minimum tax; and
- extension of several tax provisions that are scheduled to expire, including the R&E tax credit, work opportunity and welfare-to-work tax credits, and the so-called "brownfields" expensing provision.

The President's plan also includes a package of provisions that would simplify the administration of the Federal tax laws.

The following is a more detailed summary of the tax incentive provisions included in the President's plan.

1. MAKE HEALTH CARE MORE AFFORDABLE

Long-term care and disabled workers credits.—Deductions available under current law for long-term care and work-related impairment expenses do not benefit taxpayers who claim the standard deduction and, even if a taxpayer itemizes deductions, do not cover all formal and informal costs of providing assistance to individuals with long-term care needs or to disabled individuals who work. In recognition of such formal and informal long-term care costs and their effect on a taxpayer's ability to pay taxes, the President's plan would allow taxpayers to claim a new long-term care credit of $1,000 if the taxpayer, a spouse, or an individual receiving support from (or residing with) the taxpayer has "long-term care needs." An individual generally would have "long-term care needs" if unable for at least six months to perform at least three activities of daily living without substantial assistance from another individual, or if unable to perform at least one activity of daily living or certain age appropriate activities due to severe cognitive impairment.

In addition, the President's plan would help compensate taxpayers with disabilities for costs associated with work (e.g., personal assistance or special transportation) by allowing taxpayers with earned income to claim a $1,000 credit if the taxpayer is unable for at least 12 months to perform at least one activity of daily living without substantial assistance from another individual.

To claim one (or possibly both) of the credits, taxpayers would be required to obtain a physician's certification to demonstrate the required level of long-term care needs, but would not be required to substantiate any particular out-of-pocket expenses. The proposed credits would be phased out—in combination with the current-law $500 child credit—for certain higher-income taxpayers.

Small business health plans.—The President's plan would make health care costs more affordable by assisting small businesses in their efforts to provide health insurance to employees. Small businesses generally face higher costs than do larger employers in providing health plans to their employees, which has led to a significantly higher percentage of small business employees being uninsured compared to the national average. Health benefit purchasing coalitions pool employer workforces and provide an opportunity to purchase health insurance at a reduced cost, but such coalitions have been hindered by limited access to capital. In response, the President's plan includes a special, temporary rule that would allow tax-exempt private foundations to make grants or loans prior to January 1, 2004, to qualified health benefit purchasing coalitions to support the coalition's initial operating expenses.

Moreover, the President's plan would allow employers that have fewer than 50 employees and that did not have an employee health plan during 1997 or 1998 to claim a 10-percent credit for certain premium payments made for employee health insurance purchased through a qualified coalition. The proposed credit would be allowed for health plans established before January 1, 2004, and would be allowed for contributions made during the first 24 months that an employer purchases health insurance through a qualified coalition.

2. EXPAND EDUCATION INITIATIVES

School construction and modernization.—Because many school systems lack sufficient fiscal capacity to respond to aging school buildings and growing enrollments, the President's plan includes a new tax credit bond program that would leverage Federal support to spur new State and local investment in elementary and secondary school modernization. Under this program, State and local governments (including U.S. possessions) would be authorized to issue up to $22 billion of "qualified school modernization bonds" ($11 billion in each of 2000 and 2001). One half of the $22 billion cap would be allocated among the 100 school districts with the largest number of children living in poverty and up to 25 additional school districts with particular needs of assistance. The remaining half of the $22 billion cap would be allocated among the States and Puerto Rico. In addition, $400 million of bonds ($200 million in each of 2000 and 2001) would be allocated for construction and renovation of Bureau of Indian Affairs funded schools.

A holder of these bonds would receive annual Federal income tax credits, set according to market interest rates by the Treasury Department, in lieu of interest being paid by the State or local government. At least 95 percent of the bond proceeds of a qualified school modernization bond must be used (generally within 3 years of the date of issuance) to finance public school construction or rehabilitation pursuant to a plan approved by the Department of Education. Issuers would be responsible for repayment of principal after a maximum term of 15 years.

The President's plan also provides for expansion of the current-law "qualified zone academy bond" program, by authorizing the issuance of an additional $2.4 billion of such bonds and allowing the bond proceeds to be used for new school construction.

Other education incentives.—To expand educational opportunities throughout a taxpayer's lifetime, the President's budget plan also includes the following provisions that build on current-law tax incentives for education: (1) extend section 127 exclusion for employer-provided educational assistance through the end of the year 2001 and expand the exclusion to apply to graduate-level courses (currently, the exclusion is limited to undergraduate courses beginning before June 1, 2000); (2) eliminate the current-law rule under section 221 that limits deductible student loan interest to interest paid only during the first 60 months that interest payments are required on a loan (this will simplify greatly the student loan interest deduction provision); (3) eliminate tax liability when Federal student loan balances are canceled after the student finishes making income-contingent payments on the loan; (4) provide tax-free treatment for certain awards under the National Health Service Corps scholarship and loan repayment programs, the Armed Forces Health Professions scholarship and loan repayment programs, and the Americorps loan repayment program; (5) provide for an allocated tax credit to encourage corporate sponsorship of qualified zone academies in designated empowerment zones and enterprise communities; and (6) allow employers to claim a 10-percent credit (up to $525 per eligible employee) for certain workplace literacy programs that provide basic skills instruction at or below the level of a high school degree or English literacy.

3. MAKING CHILD CARE MORE AFFORDABLE

Increase, expand and simplify the child and dependent care tax credit.—Many working parents cannot find affordable and safe child care. The needs of moderate-income families can best be served through an expansion of the current-law child and dependent care tax credit, which was last increased in 1982. The President's plan would increase the maximum credit rate from 30 percent to 50 percent, and would extend eligibility for the maximum credit rate to taxpayers with adjusted gross incomes of $30,000 (rather than $10,000 as under current law). The new 50-percent credit rate would be phased down gradually for taxpayers with adjusted gross incomes between $30,000 and $59,000. The credit rate would be 20 percent for taxpayers with adjusted gross incomes over $59,000.

In addition, to enable parents to make the best choices for caring for their infants, who require special care and attention, the President's plan would further expand the eligibility for the child and dependent care tax credit. Parents with infants under the age of one would be eligible for an additional credit amount, even if the parent stays at home to care for the infant rather than working outside the home and incurring out-of-pocket child care expenses. Under the proposal, a taxpayer who resides with his or her infant under the age of one would be deemed to have child care expenses of $500 ($1,000 for two or more infants under the age of one). Taxpayers residing with children under the age of one who also incur out-of-pocket child care expenses in order to work would simply add such out-of-pocket expenses to the deemed $500 (or $1,000) of child care expenses, and would then calculate the section 21 credit by multiplying deemed and actual out-of-pocket child care expenses by the applicable 20- to 50-percent credit rate.

The President's plan would simplify eligibility for the credit by eliminating the complicated household maintenance test under current law (except that a married taxpayer filing a separate return would still have to meet the current-law household maintenance test in order to qualify for the credit). In addition, to ensure that the credit retains its value over time, certain credit parameters would be indexed for inflation.

Employer-provided child care credit.—As part of the Administration's comprehensive initiative to address child care needs of working families, the President's plan would allow employers to claim a credit equal to 25 percent of expenses incurred to build or acquire a child care facility for employee use, or to provide child care services to children of employees directly or through a third party. Employers also would be entitled to a credit equal to 10 percent of expenses incurred to provide employees with child care resource and referral services. A taxpayer's total credit could not exceed $150,000 per taxable year.

4. INCENTIVES TO REVITALIZE COMMUNITIES

Better America Bonds.—Conventional tax-exempt bonds may not provide a deep enough subsidy to induce State and local governments to undertake environmental projects with diffuse public benefits. Accordingly, the President's plan includes a new tax credit bond program, under which States and local governments (including U.S. possessions and Native American tribal governments) would be authorized to issue an aggregate of $9.5 billion of "Better America Bonds." Similar to the President's school modernization bond proposal (discussed above) and the current-law qualified zone academy bonds, holders of such bonds would receive annual Federal income tax credits in lieu of interest being paid by the State or local government. At least 95 percent of the bond proceeds must be used (generally within 3 years of the date of issuance) to finance projects to protect open spaces or accomplish certain other qualified environmental purposes. The Environmental Protection Agency would allocate bond authority to particular environmental projects based on a competitive application process. Issuers of the bonds would be responsible for repayment of principal after a maximum term of 15 years.

New Markets Tax Credit.—Businesses located in low-income urban and rural communities often lack access to sufficient equity capital. To attract new capital to these businesses, taxpayers would be allowed a credit against Federal income taxes for certain investments made to acquire stock (or other equity interests) in a community development investment entity selected by the Treasury Department to receive a credit allocation. The Treasury Department would authorize selected community development entities to issue up to a total of $6 billion of equity interests with respect to which investors could claim a credit equal to approximately 25 percent (in present-value terms) of the investment.

Under the proposal, selected community development investment entities, in turn, would be required to use the investment proceeds to provide loans or equity capital to qualified active business located in low-income communities. Such businesses generally would be required to satisfy the requirements for "enterprise zone businesses" under current law and must be located in census tracts with either (1) poverty rates of at least 20 percent or (2) median family income which does not exceed 80 percent of metropolitan area family income (or 80 percent of non-metropolitan statewide family income in the case of a non-metropolitan census tract). There would be no requirement that employees of a qualified active business be residents of a low-income community.

Increase low-income housing tax credit per capita cap.—Most State agencies receive more qualified proposals for low-income rental housing than can be undertaken with the current-law State limitation for the low-income housing tax credit. This limitation has not changed since it was established in 1986. Accordingly, the President's plan would increase the current-law $1.25 per capita limitation for the low-income housing tax credit to $1.75 per capita. This increase would allow additional low-income housing to be provided but still would require that State agencies choose projects that meet specific housing needs.

Other provisions.—As additional incentives to revitalize communities, the President's plan would (1) enhance the current-law provisions that allow certain investment gains to be rolled over on a tax-free basis to purchase stock in a specialized small business investment company (SSBIC) and that provide a partial capital gains exclusion for the sale of such stock held for more than five years; and (2) provide that businesses located in the two new empowerment zones, with respect to which the zone designation takes effect on January 1, 2000 (i.e., Cleveland and Los Angeles), will be eligible to claim the empowerment zone wage credit for the full, ten-year period of zone designation, as is the case with the original nine empowerment zones designated in 1994.

5. ENERGY EFFICIENCY AND ENVIRONMENTAL IMPROVEMENT

In an effort to improve the environment, the President's budget proposes $3.6 billion in tax incentives to promote energy efficiency and to reduce emissions of greenhouse gases.

Energy-efficient buildings would be encouraged by a tax credit of up to $2,000 for the purchase of highly energy-efficient new homes, and by a 10 or 20 percent credit (subject to a cap) for the purchase of certain energy-efficient building equipment (fuel cells, electric heat pump water heaters, natural gas heat pumps, electric heat pumps, natural gas water heaters, and advanced central air conditioners). The credit for energy-efficient homes would apply to purchases in calendar years 2000 through 2004 and the credit for energy-efficient building equipment would apply to purchases in calendar years 2000 through 2003.

Transportation-related incentives would encourage the purchase of electric vehicles and highly energy-efficient hybrid vehicles. The current-law credit of up to $4,000 for the purchase of a qualifying electric vehicle would be extended through 2006, and a new credit of up to $4,000 would be allowed in calendar years 2003 through 2006 for purchases of fuel-efficient hybrid vehicles.

The Administration's budget proposals would also promote increased energy efficiency through the use of combined heat and power (CHP) technologies by allowing an 8-percent investment tax credit for qualifying CHP equipment placed in service in calendar years 2000 through 2002.

Finally, tax incentives would be provided for the increased use of renewable energy sources: a credit of up to $2,000 would be allowed for solar photovoltaic equipment placed in service during calendar years 2000 through 2006 and of up to $1,000 for solar hot water heating systems placed in service during calendar years 2000 through 2005. In addition, the current-law tax credit for electricity produced from wind or biomass would be extended for five years. For this purpose, eligible biomass sources would be expanded to include certain biomass derived from forest-related resources and agricultural sources, and a reduced credit would be allowed for co-firing biomass in coal plants.

6. EXPANDED RETIREMENT SAVINGS, SECURITY, AND PORTABILITY

With changing demographics, it is especially important to increase retirement savings. Much of the legislation enacted in recent years has been successful in expanding retirement savings, providing incentives to individuals and employers. Approximately two-thirds of the retirement savings in this country (exclusive of annuity contracts) is employer-provided retirement savings. Employer-provided pensions currently benefit 50 million workers. The President's budget encourages savings through employer-provided plans.

While the employer system is strong, we cannot be content. Half of all American workers—more than 50 million people—have no pension plan at all. Women have less pension coverage than men. Only 30 percent of all women aged 65 or older were receiving a pension in 1994 (either worker or survivor benefits) compared to 48 percent of men. An increasingly mobile workforce makes accumulating and managing retirement benefits more difficult. Workers frustrated by keeping track of their various retirement accounts are tempted to cash out their retirement benefits and spend these all important savings on current consumption. Two-thirds of workers receiving a lump sum distribution from a pension plan do not roll over the distribution into retirement savings.

We need to continue to promote retirement savings by enacting pension legislation to expand the number of people who will have employer-provided pensions, by simplifying the pension laws for business, by improving pension funding and making pensions more secure and portable for workers.

The President's budget includes several incentives to encourage the provision of retirement benefits by small business. First, a three-year tax credit is provided to encourage small businesses to set up retirement programs. Second, to make it easier for workers to make contributions to Individual Retirement Accounts (IRAS), employers would be encouraged to offer payroll deduction programs. Third, the President's plan provides a simplified defined benefit-type plan for small business, known as the "SMART Plan." The Administration's proposal is similar in many respects to the bipartisan "SAFE plan" proposal of Representatives Earl Pomeroy and Nancy Johnson. The SMART (Secure Money Annuity or Retirement Trust) plan combines many of the best features of defined benefit and defined contribution plans and provides another easy-to-administer pension option for small businesses. Most nondiscrimination rules and a number of other pension plan requirements would be waived for this new plan. SMART plans would be an option for most small businesses with 100 or fewer employees that do not offer (and have not offered during the last 5 years) a defined benefit or money purchase plan. Employers choosing a SMART plan would make contributions for all eligible workers (over 21 with at least $5,000 in W–2 earnings with the employer in that year and in two preceding consecutive years). Participants would be *guaranteed* a minimum annual benefit upon retirement, but could receive a larger benefit if the return on plan investments exceeds specified conservative assumptions (i.e., a 5 percent rate of return). The SMART benefit would generally be guaranteed by the Pension Benefit Guaranty Corporation, at a reduced premium.

To make it easier to consolidate retirement savings, the President's budget provides rules to permit eligible rollover distributions from a qualified retirement plan to be rolled over into a Section 403(b) tax-sheltered annuity or visa versa; to allow rollovers from non qualified deferred compensation plans of state or local government (Section 457 plans) to be rolled over into an IRA; to permit rollovers of IRAs into workplace retirement plans; to allow rollovers of after-tax contributions to new employer's defined contribution plan or an IRA if separate tracking of after-tax contribution is provided; to allow the Thrift Savings Plan (a retirement savings plan for federal government employees) to accept tax-free rollovers from private plans; and to allow employees of state and local governments to use funds in their retirement plans to purchase service credits in new plans without a taxable distribution. This allows teachers who often move between state and school districts in the course of their careers to more easily earn a pension reflecting a full career of employment in the state in which they end their career.

7. EXTENSION OF EXPIRING PROVISIONS

The President's plan includes the extension of several important tax incentive provisions that are scheduled to expire in 1999, including (1) a one-year extension of the R&E tax credit to apply to qualified research conducted before July 1, 2000 (and extension of the credit to qualified research conducted in Puerto Rico), and (2) one-year extensions of the work opportunity tax credit and welfare-to-work tax credit to cover employees who begin work before July 1, 2000.

The President's plan also proposes extending through the year 2001 the recently enacted tax credit for the first-time purchase of a principal residence in the District of Columbia (which currently is scheduled to expire at the end of the year 2000).

In addition, the President's plan would make permanent the so-called "brownfields" provision, which allows taxpayers to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The "brownfields" provision currently is scheduled to expire at the end of the year 2000.

AMT Relief

Of particular importance to individual taxpayers, the Administration proposes to extend, for two years, the provision enacted in 1998 that allows an individual to offset his or her regular tax liability by nonrefundable tax credits—such as the education credits and the child credit—regardless of the amount of the individual's tentative minimum tax. The Administration is concerned that the individual alternative minimum tax (AMT) may impose financial and compliance burdens upon taxpayers that have few tax preference items and were not the originally intended targets of the AMT. In particular, the Administration is concerned that the individual AMT may act to erode the benefits of nonrefundable tax credits that are intended to provide relief for middle-income taxpayers. During the proposed extension period, the Administration hopes to work with Congress to develop a longer-term solution to the individual AMT problem.

8. SIMPLIFICATION PROVISIONS

The President's plan includes several other provisions that would simplify the administration of Federal tax laws. These provisions would: (1) extend the current-law rule for farmers to all self-employed individuals that allows individuals to elect to increase their self-employment income for purposes of obtaining social security coverage; (2) provide statutory hedging and other rules (generally codifying rules previously promulgated by the Treasury Department) to ensure that business property is treated as ordinary property; (3) clarify rules relating to certain disclaimers by donees of gifts or bequests; (4) simplify the foreign tax credit limitation for dividends from so-called "10/50 companies"; (5) eliminate the U.S. withholding tax on distributions from U.S. mutual funds that hold substantially all of their assets in cash or U.S. debt securities (or foreign debt securities that are not subject to withholding tax under foreign law); (6) expand the declaratory judgment relief available under current-law to charities to all organizations seeking tax-exempt status under section 501(c); and (6) simplify the active trade or business requirement for tax-free corporate spin-offs. The Administration hopes to work with the Congress to develop and enact additional, appropriate simplification measures.

9. MISCELLANEOUS PROVISIONS

Other targeted tax incentives included in the President's plan include a proposed extension and modification of the current-law Puerto Rico economic-activity credit, to provide a more efficient and effective tax incentive for the economic development of Puerto Rico.

In addition, to reduce the burdens faced by displaced workers, the President's plan would exclude up to $2,000 of certain severance payments from the income of the recipient. This exclusion would apply to payments received by an individual who was separated from service in connection with a reduction in the employer's work force, but only if the individual does not attain employment within six months of the separation from service at a compensation level that is at least 95 percent of the compensation the individual received before the separation from service and only if total severance payments received by the individual do not exceed $75,000.

To address the financial troubles of the steel industry, the President's plan would extend to 5 years the carryback period for the net operating loss (NOL) of a steel company. An eligible taxpayer could elect to forgo the 5-year carryback and apply the current-law carryback rules. The benefit proposed would feed directly into a financially troubled steel company's cash flow, providing immediate needed relief.

10. ELECTRICITY RESTRUCTURING

Restructuring the electric industry to encourage retail competition promises significant economic benefits to both business and household consumers of electricity. In order to reap the benefits of restructuring, steps must be taken to provide a level playing field for investor-owned and publicly-owned electric systems as well as to provide relief from the rules governing private use of tax-exempt bond-financed electric facilities in appropriate circumstances. The President's plan provides that no new facilities for electric generation or transmission may be financed with tax-exempt bonds. Distribution facilities may continue to be financed with tax-exempt bonds subject to existing private use rules. Distribution facilities are facilities operating at 69 kilovolts or less (including functionally related and subordinate property). In order to develop efficient nondiscriminatory transmission services, publicly-owned electric utility companies may be required to turn the operation of their transmission facilities over to independent systems operators or use those facilities in a manner that may violate the private use rules. In addition, as traditional service areas of both investor-owned and publicly-owned systems are opened to retail competition, the latter may find it necessary to enter into contracts with private users of electricity in order to prevent their generation facilities from becoming stranded costs. Without relief from the private use rules, publicly-owned electric systems may not choose to open their service areas to competition or to allow their transmission facilities to be operated by a private party.

In response, the President's plan provides that bonds issued to finance transmission facilities prior to the enactment of legislation to implement restructuring would continue their tax-exempt status if private use results from action pursuant to a Federal order requiring non-discriminatory open access to those facilities. In addition, bonds issued to finance generation or distribution facilities issued prior to enactment of such legislation would continue their tax-exempt status if private use results from retail competition, or if private use results from the issuer entering into a contract for the sale of electricity or use of its distribution property that will become effective after implementation of retail competition. Sale of facilities financed with tax-exempt bonds to private entities would continue to constitute a change in use. Bonds issued to refund, but not advance refund, bonds issued before enactment of legislation implementing restructuring would be permitted.

Finally, the President's plan would amend the rules applicable to nuclear decommissioning funds in order to address issues raised by the restructuring of the electric industry.

Revenue offsets

Our revenue offsets would curtail corporate tax shelters, and close loopholes in the tax law in the areas of financial products, corporate taxes, pass-through entities, tax accounting, cost recovery, insurance, exempt organizations, estate and gift taxation, taxation of international transactions, pensions, compliance, and others. These offsets generally would be effective with respect to a future date (e.g., date of first committee action, or date of enactment). We look forward to working with the committee to develop grandfather rules where appropriate.

CORPORATE TAX SHELTERS

The Administration believes there has been an increase in the use of corporate tax shelters and is concerned about this proliferation for several reasons. First, corporate tax shelters reduce the corporate tax base. Congress intended corporations to be a source of Federal revenue in enacting the various provisions of the corporate income tax. Questionable transactions that reduce corporate tax liability frustrate this intent. Moreover, corporate tax shelters erode the integrity of the tax system as a whole. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in transactions unavailable to most other taxpayers may lead to a perception of unfairness and, if unabated, may lead to a decrease in voluntary compliance. Finally, the significant resources used to create, implement and defend complex sheltering transactions are better used in productive activities. Similarly, the IRS must expend significant resources to combat such transactions.

To date, most attacks on corporate tax shelters have been targeted at specific transactions and have occurred on an ad-hoc, after-the-fact basis—through legislative proposals, administrative guidance, and litigation. At the Treasury Department, a number of actions have been taken to address corporate tax shelters. For example, we've made legislative proposals aimed at section 357(c) basis creation abuses, which has advanced in both chambers, and liquidating REITs, which was enacted last year. On the regulatory front, we have issued guidance, such as the notice on stepped-down preferred, fast-pay, slow-pay transactions, and in litigation, we've won two important cases—*ACM* and *ASA*. But we often hear that we are only hitting the tip of the iceberg.

Addressing corporate tax shelters on a transaction-by-transaction, ad hoc basis, however, raises certain concerns. First, it is not possible to identify and address all current and future sheltering transactions. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions the treatment of which is less clear. Second, legislating on a piecemeal basis further complicates the Code and seemingly calls into question the viability of common law tax doctrines such as sham transaction, business purpose, economic substance and substance over form. Finally, using a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the belief that any retroactive legislation would be applied only on a prospective basis.

The primary goal of any corporate tax shelter is to eliminate, reduce, or defer corporate income tax. To achieve this goal, corporate tax shelters are designed to manufacture tax benefits that can be used to offset unrelated income of the taxpayer or to create tax-favored or tax-exempt economic income. Most corporate tax shelters rely on one or more discontinuities in the tax law, or exploit a provision in the Code or Treasury regulations in a manner not intended by Congress or the Treasury Department.

Corporate tax shelters may take several forms. For this reason, they are hard to define. However, corporate tax shelters often share certain common characteristics. For example, through hedges, circular cash flows, defeasements, or other devices, corporate participants in a shelter often are insulated from any risk of economic loss or opportunity for economic gain with respect to the sheltering transaction. Thus, corporate tax shelters are transactions without significant economic substance, entered into principally to achieve a desired tax result. Similarly, the financial accounting treatment of a shelter generally is significantly more favorable than the corresponding tax treatment; that is, the shelter produces a tax "loss" that is not reflected as a book loss. However, the corporate tax shelter may produce a book earnings benefit by reducing the corporation's effective tax rate.

Corporate tax shelter schemes often are marketed by their designers or promoters to multiple corporate taxpayers and often involve property or transactions unrelated to the corporate participant's core business. These two features may distinguish corporate tax shelters from traditional tax planning.

Many corporate tax shelters involve arrangements between corporate taxpayers and persons not subject to U.S. tax such that these tax indifferent parties absorb the taxable income from the transaction, leaving tax losses to be allocated to the corporation. The tax indifferent parties in effect "rent" their tax exempt status in return for a accomodation fee or an above-market return on investment. Tax indifferent parties include foreign persons, tax-exempt organizations, Native American tribal organizations, and taxpayers with loss or credit carryforwards.

Taxpayers entering into corporate tax shelter transactions often view such transactions as risky because the expected tax benefits may be successfully challenged. To protect against such risk, purchasers of corporate tax shelters often require the seller or a counterparty to enter into a tax benefit protection arrangement. Thus, corporate tax shelters are often associated with high transactions costs, contingent or refundable fees, unwind clauses, or insured results.

These themes run through our budget proposals and, we hope, help us to focus on finding broader, ex ante solutions to the corporate tax shelter problem.

The Administration therefore proposes several remedies to curb the growth of corporate tax shelters. We propose more general remedies to deter corporations from entering into any sheltering transactions. These proposals would disallow any tax benefit created in a corporate tax shelter, as so defined, and would address common characteristics found in corporate tax shelters as described above. Also, all the parties to a structured transaction would have an incentive, under our proposals, to assure that the transaction comports with established principles.

The Treasury Department recognizes that this more general approach to corporate tax shelters raises certain concerns. Applying various substantive and procedural rules to a "corporate tax shelter" or a "tax avoidance transaction" requires definitions of such terms. As described in greater detail below, the Administration's proposals define these terms. Critics of the proposals have suggested that these definitions are too broad or may create too much uncertainty and thus may inhibit otherwise legitimate transactions. The Treasury Department does not intend to affect legitimate business transactions and looks forward to working with the tax-writing committees in refining the corporate tax shelter proposals. However, some level of uncertainty is unavoidable with respect to complex transactions. In addition, the definition of corporate tax shelter as used in our proposals is narrower and therefore less uncertain than other definitions and formulations used in the Code. Moreover, the definition we have proposed is similar to existing articulations of various judicial doctrines and may be viewed as largely enforcing the judicially-created concept of economic substance of current law. Finally, some amount of uncertainty may be useful in discouraging taxpayers from venturing to the edge, thereby risking going over the edge, of established principles.

The Administration's proposals that generally would apply to corporate tax shelters are:

Deny certain tax benefits in tax avoidance transactions.—Under current law, if a person acquires control of a corporation or a corporation acquires carryover basis property of a corporation not controlled by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing certain tax benefits, the Secretary may disallow such benefits to the extent necessary to eliminate such evasion or avoidance of tax. However, this current rule has been interpreted narrowly. The Administration proposes to expand the current rules to authorize the Secretary to disallow a deduction, credit, exclusion, or other allowance obtained by a corporation in a tax avoidance transaction.

For this purpose, a tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income. The proposal would not apply to tax benefits clearly contemplated by the applicable current-law provision (e.g., the low-income housing tax credit).

Modify substantial understatement penalty for corporate tax shelters.—The current 20-percent substantial understatement penalty imposed on corporate tax shelter items can be avoided if the corporate taxpayer had reasonable cause for the tax treatment of the item and good faith. The Administration proposes to increase the substantial understatement penalty on corporate tax shelter items to 40 percent.

The penalty will be reduced to 20 percent if the corporate taxpayer discloses to the National Office of the Internal Revenue Service within 30 days of the closing of the transaction appropriate documents describing the corporate tax shelter and files a statement with, and provides adequate disclosure on, its tax return. The penalty could not be avoided by a showing of reasonable cause and good faith. For this purpose, a corporate tax shelter would be defined as any entity, plan, or arrangement (to be determined based on all the facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

Deny deductions for certain tax advice and impose an excise tax on certain fees received.—The proposal would deny a deduction for fees paid or accrued in connection with the promotion of corporate tax shelters and the rendering of certain tax advice related to corporate tax shelters. The proposal would also impose a 25-percent excise tax on fees received in connection with the promotion of corporate tax shelters and the rendering of certain tax advice related to corporate tax shelters.

Impose excise tax on certain rescission provisions and provisions guaranteeing tax benefits.—The Administration proposes to impose on the purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment to be made under the arrangement. For this purpose, a tax benefit protection arrangement would include certain rescission clauses, guarantee of tax benefits arrangement or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction).

Preclude taxpayers from taking tax positions inconsistent with the form of their transactions.—Under current law, if a taxpayer enters into a transaction in which the economic substance and the legal form are different, the taxpayer may take the position that, notwithstanding the form of the transaction, the substance is controlling for Federal income tax purposes. Many taxpayers enter into such transactions in order to arbitrage tax and regulatory laws. Under the proposal, except to the extent the taxpayer discloses the inconsistent position on its tax return, a corporate taxpayer, but not the Internal Revenue Service, would be precluded from taking any position (on a tax return or otherwise) that the Federal income tax treatment of a transaction is different from that dictated by its form, if a tax indifferent person has a direct or indirect interest in such transaction.

Tax income from corporate tax shelters involving tax-indifferent parties.—The proposal would provide that any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable, either to the tax-indifferent party or to the corporate participant.

The Administration also proposes to amend the substantive law related to specific transactions that the Treasury Department has identified as giving rise to corporate tax shelters. No inference is intended as to the treatment of any of these transactions under current law.

Require accrual of income on forward sale of corporate stock.—There is little substantive difference between a corporate issuer's current sale of its stock for a deferred payment and an issuer's forward sale of the same stock. In both cases, a portion of the deferred payment compensates the issuer for the time-value of money during the term of the contract. Under current law, the issuer must recognize the time-value element of the deferred payment as interest if the transaction is a current sale for deferred payment but not if the transaction is a forward contract. Under the proposal, the issuer would be required to recognize the time-value element of the forward contract as well.

Modify treatment of built-in losses and other attribute trafficking.—Under current law, a taxpayer that becomes subject to U.S. taxation may take the position that it determines its beginning bases in its assets under U.S. tax principles as if the taxpayer had historically been subject to U.S. tax. Other tax attributes are computed similarly. A taxpayer may thus "import'" built-in losses or other favorable tax attributes incurred outside U.S. taxing jurisdiction (e.g., from foreign or tax-exempt parties) to offset income or gain that would otherwise be subject to U.S. tax. The proposal would prevent the importation of attributes by eliminating tax attributes (including built-in items) and marking to market bases when an entity or an asset becomes relevant for U.S. tax purposes. This proposal would be effective for transactions in which assets or entities become relevant for U.S. tax purposes on or after the date of enactment.

Modify treatment of ESOP as S corporation shareholder.—Pursuant to provisions enacted in 1996 and 1997, an employee stock ownership plan (ESOP) may be a shareholder of an S corporation and the ESOP's share of the income of the S corporation is not subject to tax until distributed to the plan beneficiaries. The Administration proposes to require an ESOP to pay tax on S corporation income (including capital gains on the sale of stock) as the income is earned and to allow the ESOP a deduction for distributions of such income to plan beneficiaries.

Prevent serial liquidation of U.S. subsidiaries of foreign corporations.—Dividends from a U.S. subsidiary to its foreign parent corporation are subject to U.S. withholding tax. In contrast, if a domestic corporation distributes earnings in a tax-free liquidation, the foreign shareholder generally is not subject to any withholding tax. Some foreign corporations attempt to avoid dividend withholding by serially forming and liquidating holding companies for their U.S. subsidiaries. The proposal would impose withholding tax on any distribution made to a foreign corporation in complete liquidation of a U.S. holding company if the holding company was in existence for less than five years. The proposal would also achieve a similar result with respect to serial terminations of U.S. branches.

Prevent capital gains avoidance through basis shift transactions involving foreign shareholders.—To prevent taxpayers from attempting to offset capital gains by generating artificial capital losses through basis shift transactions involving foreign shareholders, the Administration proposes to treat the portion of a dividend that is not subject to current U.S. tax as a nontaxed portion and thus subject to the basis reduction rules applicable to extraordinary dividends. Similar rules would apply in the event that the foreign shareholder is not a corporation.

Limit inappropriate tax benefits for lessors of tax-exempt use property.—The Administration is concerned that certain structures involving tax-exempt use property are being used to generate inappropriate tax benefits for lessors. The proposal would deny a lessor the ability to recognize a net loss from a leasing transaction involving tax-exempt use property during the lease term. A lessor would be able to carry forward a net loss from a leasing transaction and use it to offset net gains from the transaction in subsequent years. This proposal would be effective for leasing transactions entered into on or after the date of enactment.

Prevent mismatching of deductions and income inclusions in transactions with related foreign persons.—The Treasury Department has learned of certain structured transactions designed to allow taxpayers inappropriately to take advantage of the certain current-law rules by accruing deductions to related foreign personal holding company (FPHC), controlled foreign corporation (CFC) or passive foreign investment company (PFIC) without the U.S. owners of such related entities taking into account for U.S. tax purposes an amount of income appropriate to the accrual. This results in an improper mismatch of deductions and income. The proposal would provide that deductions for amounts accrued but unpaid to related foreign CFCs, PFICs or FPHCs would be allowable only to the extent the amounts accrued by the payor are, for U.S. tax purposes, reflected in the income of the direct or indirect U.S. owners of the related foreign person. The proposal would contain an exception for certain short term transactions entered into in the ordinary course of business.

Restrict basis creation through section 357(c).—A transferor generally is required to recognize gain on a transfer of property in certain tax-free exchanges to the extent that the sum of the liabilities assumed, plus those to which the transferred property is subject, exceeds the basis in the property. This gain recognition to the transferor generally increases the basis of the transferred property in the hands of the transferee. If a recourse liability is secured by multiple assets, it is unclear under current law whether a transfer of one asset where the transferor remains liable is a transfer of property "subject to the liability." Similar issues exist with respect to nonrecourse liabilities. Under the Administration's proposal, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally would be eliminated. The transferor's recognition of gain as a result of assumption of liability would not increase the transferee's basis in the transferred asset to an amount in excess of its fair market value. Moreover, if no person is subject to U.S. tax on gain recognized as the result of the assumption of a nonrecourse liability, then the transferee's basis in the transferred assets would be increased only to the extent such basis would be increased if the transferee had assumed only a ratable portion of the liability, based on the relative fair market values of all assets subject to such nonrecourse liability.

Modify anti-abuse rule related to assumption of liabilities.—The assumption of a liability in an otherwise tax-free transaction is treated as boot to the transferor if the principal purpose of having the transferee assume the liability was the avoidance of tax on the exchange. The current language is inadequate to address the avoidance concerns that underlie the provision. The Administration proposes to modify the anti-abuse rule by deleting the limitation that it only applies to tax avoidance on the exchange itself, and changing "the principal purpose" standard to "a principal purpose."

Modify corporate-owned life insurance (COLI) rules.—In general, interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts is not deductible unless the insurance contract insures the life of a "key person" of a business. In addition, the interest deductions of a business generally are reduced under a proration rule if the business owns or is a direct or indirect beneficiary with respect to certain insurance contracts. The COLI proration rules generally do not apply if the contract covers an individual who is a 20-percent owner of the business or is an officer, director, or employee of such business. These exceptions under current law still permit leveraged businesses to fund significant amounts of deductible interest and other expenses with tax-exempt or tax-deferred inside buildup on contracts insuring certain classes of individuals. The Administration proposes to repeal the exception under the COLI proration rules for contracts insuring employees, officers or directors (other than 20-percent owners) of the business. The proposal also would conform the key person exception for disallowed interest deductions attributable to policy loans and other indebtedness with respect to life insurance contracts to the 20-percent owner exception in the COLI proration rules.

OTHER REVENUE PROVISIONS

In addition to the general and specific corporate tax shelter proposals, the Administration's budget contains other revenue raising proposals that are designed to remove unwarranted tax benefits, ameliorate discontinuities of current law, provide simplification and improve compliance. Some of these proposals are described below.

PROPOSALS RELATING TO FINANCIAL PRODUCTS

The proposals relating to financial products narrowly target certain transactions and business practices that inappropriately exploit existing tax rules. Three of the proposals address the timing of income from debt instruments. Other proposals address specific financial products transactions that are designed to achieve tax results that are significantly better than the results that would be obtained by entering into economically equivalent transactions. At the same time, a number of these proposals contain provisions that are designed to simplify existing law and provide relief for taxpayers in cases where the literal application of the existing rules can produce an uneconomic result.

Mismeasurement of economic income.—The tax rules that apply to debt instruments generally require both the issuer and the holder of a debt instrument to recognize interest income and expense over the term of the instrument regardless of when the interest is paid. If the debt instrument is issued at a discount (that is, it is issued for an amount that is less than the amount that must be repaid), the discount functions as interest—as compensation for the use of money. Recognizing this fact, the existing tax rules require both parties to account for this discount as interest over the life of the debt instrument.

The Administration's budget contains three proposals that are designed to reduce the mismeasurement of economic income on debt instruments: (1) a rule that requires cash-method banks to accrue interest income on short-term obligations, (2) rules that require accrual method taxpayers to accrue market discount, and (3) a rule that requires the issuer in a debt-for-debt exchange to spread the interest expense incurred in the exchange over the term of the newly-issued debt instrument.

Specific transactions designed to exploit current rules.—There are a number of strategies involving financial products that are designed to give a taxpayer the "economics" of a particular transaction without the tax consequences of the transaction itself. For example, so-called "hedge fund swaps" are designed to give an investor the "economics" of owning a partnership interest in a hedge fund without the tax consequences of being a partner. These swaps purportedly allow investors to defer the recognition of income until the end of the swap term and to convert ordinary income into long-term capital gain.

Another strategy involves the used of structured financial products that allow investors to monetize appreciated financial positions without recognizing gain. If a taxpayer holds an appreciated financial position in personal property and enters into a structured financial product that substantially reduces the taxpayer's risk of loss in the appreciated position, the taxpayer may be able to borrow against the combined position without recognizing gain. Under current law, unless the borrowing is "incurred to purchase or carry" the structured financial product, the taxpayer may deduct its interest expense on the borrowing even though the taxpayer has not included the gain from the appreciated position.

The Administration's budget contains proposals that are designed to eliminate the inappropriate tax benefit these transactions create. The "constructive ownership" proposal would limit the amount of long-term capital gain a taxpayer could recognize from a hedge fund swap to the amount of long-term capital gain that would have been recognized if the investor had invested in the hedge fund directly. Another proposal would clarify that a taxpayer cannot currently deduct expenses (included interest expenses) from a transaction that monetizes an appreciated financial position without triggering current gain recognition.

PROPOSALS RELATING TO PASS-THROUGH ENTITIES

There are five coordinated proposals relating to basis adjustments and gain recognition in the partnership area. The proposals have three purposes: simplification, rationalization, and prevention of tax avoidance. The proposals accomplish these goals through a variety of means. In one proposal, the ability of taxpayers to elect whether or not to adjust the basis of partnership assets is eliminated in a situation where the election is leading to tax abuses. In another proposal, we would limit basis adjustments with respect to particular types of property, which enables us, in a different proposal, to repeal a provision that has been widely criticized as overly complex and irrational.

In addition to the partnership proposals, two REIT proposals are included in the budget. One proposal allows REITs to conduct expanded business activities in situations where a corporate level tax will be collected with respect to such activities. The other REIT proposal limits closely held REITs, which have been the primary vehicle for carrying out such corporate tax shelters as step-down preferred stock and the liquidating REIT transactions.

A final proposal in the pass-through area would impose a tax on gain when a large C corporation converts to an S corporation.

PROPOSALS RELATING TO CORPORATE PROVISIONS

The corporate proposals focus on a developing trend in structuring dispositions of assets or stock that technically qualify as tax-free transactions, but circumvent the repeal of *General Utilities* by allowing corporations to "sell" appreciated property without recognizing any gain. There has been a proliferation of highly publicized transactions in which corporations exploit the purposes of the tax-free reorganization provisions, (i.e., to allow a corporation to change its form when the taxpayer's investment remains in corporate solution), to maximize their ability to cash out of their investments and minimize the amount of tax paid. In addition, the corporate proposals attempt to simplify the law and prevent whipsaw of the government in certain tax-free transactions.

Modify tax-free treatment for mere adjustments in form.—In order for an acquisition or distribution of appreciated assets to qualify as wholly or partly tax-free, the transaction must satisfy a series of relatively stringent requirements. If the transaction fails to satisfy the requirements, it will be taxed in accordance with the general recognition principles of the Code. After the repeal of *General Utilities*, there are few opportunities to dispose of appreciated assets without a tax liability, and our proposals would help to ensure that those remaining exceptions to the repeal of *General Utilities* are not circumvented. The provisions of the Code that allow for tax-free treatment date back to the early years of the tax system and did not contemplate the creative tax planning that has taken place in the last several years. As a result, many of the corporate tax provisions have been manipulated, resulting in avoidance of tax.

The Administration's budget contains several proposals that are designed to eliminate opportunities under current law for corporations to achieve tax-free treatment for transactions that should be taxable. The proposals include (1) modifying the "control" test for purposes of tax-free incorporations, distributions and reorganizations to include a value component so that corporations may not "sell" a significant amount of the value of the corporation while continuing to satisfy the current law control test that focuses solely on voting power, (2) requiring gain recognition upon the issuance of "tracking stock" or a recapitalization of stock or securities into tracking stock, and (3) requiring gain recognition in downstream transactions in which a corporation that holds stock in another corporation transfers its assets to that corporation in exchange for stock.

Preventing taxpayers from taking inconsistent positions in certain nonrecognition transactions.—No gain or loss is recognized upon the transfer of property to a controlled corporation in exchange for stock. There is an inconsistency in the treatment by the Internal Revenue Service and the Claims Court as to the treatment of a transfer of less than all substantial rights to use intangible property. Accordingly, transferor and transferee corporations have taken the position that best achieves their tax goals. The proposal would eliminate this whipsaw potential by treating any transfer of an interest in intangible property as a tax-free transfer and requiring allocation of basis between the retained rights and the transferred rights based upon respective fair market values.

PROPOSALS RELATING TO TAX ACCOUNTING AND COST RECOVERY

The Administration's budget contains measures that are principally designed to improve measurement of income by eliminating methods of accounting that result in a mismeasurement of economic income or provide disparate treatment among similarly situated taxpayers.

Repeal installment method for accrual basis taxpayers.—The proposal would repeal the installment method of accounting for accrual method taxpayers (other that those taxpayers that benefit from dealer disposition exceptions under current law) and eliminate inadequacies in the installment method pledging rules in order to better reflect the economic results of a taxpayer's business during the taxable year.

Apply uniform capitalization rules to tollers.—To eliminate the disparate treatment between manufacturers and tollers and better reflect the income of tollers, the proposal would require tollers (other than small businesses) to capitalize their direct costs and an allocable portion of their indirect costs to property tolled.

Provide consistent amortization periods for intangibles.—To encourage the formation of new businesses, the proposal would allow a taxpayer to elect to deduct up to $5,000 each of start-up and organizational expenditures. Start-up and organizational expenditures not currently deductible would be amortized over a 15-year period consistent with the amortization period for acquired intangibles.

Clarify recovery period of utility grading costs.—The proposal would clarify and rationalize current law by assigning electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines to the class life assigned to the benefitted assets, giving these costs a recovery period of 20 years and 15 years, respectively. The class life assigned to the benefitted assets is a more appropriate estimate of the useful life of these costs, and thus will improve measurement of the utility's income.

Deny change in method treatment to tax-free formations.—The proposal would eliminate abuses with respect to changes in accounting methods by expanding the transactions to which the carryover of method of accounting rules apply to include tax-free contributions to corporations and partnerships.

Deny deduction for punitive damages.—The deductibility of punitive damage payments under current law undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities. The proposal would disallow any deduction for punitive damages to conform the tax treatment to that of other payments, such as penalties and fines, that are also intended to discourage violations of public policy.

Disallow interest on debt allocable to tax-exempt obligations.—Under current law, security dealers and financial intermediaries other than banks are able to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income, notwithstanding that they operate similarly to banks. The proposal would eliminate the disparate treatment between banks and financial intermediaries, such as security dealers and other financial intermediaries, by providing that a financial intermediary investing in tax-exempt obligations would be disallowed deductions for a portion of its interest expense equal to the portion of its total assets that is comprised of tax-exempt investments.

Eliminate the income recognition exception for accrual method service providers.—Under current law, accrual method service providers are provided a special exception to the general accrual rules that permit them, in effect, to reduce current taxable income by an estimate of future bad debt losses. This method of estimation results in a mismeasurement of a taxpayer's economic income and, because this tax benefit only applies to amounts to be received for the performance of services, discriminates in favor of service providers. The proposal would repeal the special exception for accrual method service providers.

Repeal lower-of-cost-or-market inventory accounting method.—The allowance of write-downs under the lower-of-cost or market (LCM) method or subnormal goods method is an inappropriate exception from the realization principle and is essentially a one-way mark-to-market method that understates taxable income. The proposal would repeal the LCM and subnormal goods methods.

PROPOSALS RELATING TO INSURANCE

The Administration's budget contains proposals to more accurately measure the economic income of insurance companies by updating and modernizing certain provisions of current law. The proposals would (1) require recapture of policyholder surplus accounts, (2) modify rules for capitalizing policy acquisition costs of life insurance companies, and (3) increase the proration percentage for property casualty (P&C) insurance companies.

Between 1959 and 1984, stock life insurance companies deferred tax on a portion of their profits. These untaxed profits were added to a policyholders surplus account (PSA). In 1984, Congress precluded life insurance companies from continuing to defer tax on future profits through PSAs. However, companies were permitted to continue to defer tax on their existing PSAs. Most pre–1984 policies have terminated so there is no remaining justification for allowing these companies to continue to defer tax on profits they earned between 1959 and 1984.

Under current law, pursuant to a provision enacted in 1990, insurance companies capitalize varying percentages of their net premiums for certain types of insurance contracts, and generally amortize these amounts over 10 years (five years for small companies). These capitalized amounts are intended to serve as proxies for each company's actual commissions and other policy acquisition expenses. However, data reported by insurance companies to State insurance regulators each year indicates that the insurance industry is capitalizing less than half of its policy acquisition costs, which results in a mismatch of income and deductions. The Administration proposes that insurance companies be required to capitalize modified percentages of their net premiums for certain lines of business.

In computing their underwriting income, P&C insurance companies deduct reserves for losses and loss expenses incurred. These loss reserves are funded in part with the company's investment income. In 1986, Congress reduced the reserve deductions of P&C insurance companies by 15 percent of the tax-exempt interest or the deductible portion of certain dividends received. In 1997, Congress expanded the 15-percent proration rule to apply to the inside buildup on certain insurance contracts. The existing 15-percent proration rule still enables P&C insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income. Other financial intermediaries, such as life insurance companies, banks and brokerage firms, are subject to more stringent proration rules that substantially reduce or eliminate their ability to use tax-exempt or tax-deferred investments to fund currently deductible reserves or deductible interest expense.

Proposals Relating to International Provisions

The Administration's budget contains proposals designed to ensure that economically similar international transactions are taxed in a similar manner, prevent manipulation and inappropriate use of exemptions from U.S. tax, allocate income between U.S. and foreign sources in a more appropriate manner, and determine the foreign tax credit in a more accurate manner. Specific proposals include:

Expand section 864(c)(4)(B) to interest and dividend equivalents.—Under U.S. domestic law, a foreign person is subject to taxation in the United States on a net income basis with respect to income that is effectively connected with a U.S. trade or business (ECI). The test for determining whether income is effectively connected to a U.S. trade or business differs depending on whether the income at issue is U.S. source or foreign source. Only enumerated types of foreign source income—rents, royalties, dividends, interest, gains from the sale of inventory property, and insurance income—constitute ECI, and only in certain circumstances. The proposal would expand the categories of foreign-source income that could constitute ECI to include interest equivalents (including letter of credit fees) and dividend equivalents in order to eliminate arbitrary distinctions between economically equivalent transactions.

Recapture overall foreign losses upon disposition of CFC stock.—If deductions against foreign income result in (or increase) an overall foreign loss which is then set against U.S. income, current law has recapture rules that require subsequent foreign income or gain to be recharacterized as domestic. Recapture can take place when directly-owned foreign assets are disposed of. However, there may be no recapture when stock in a controlled foreign corporation (CFC) is disposed of. The proposal would correct that asymmetry by providing that property subject to the recapture rules upon disposition would include stock in a CFC.

Amend 80/20 company rules.—Interest or dividends paid by a so-called "80/20 company" generally are partially or fully exempt from U.S. withholding tax. A U.S. corporation is treated as an 80/20 company if at least 80 percent of the gross income of the corporation for the three year period preceding the year of a dividend is foreign source income attributable to the active conduct of a foreign trade or business (or the foreign business of a subsidiary). Certain foreign multinationals improperly seek to exploit the rules applicable to 80/20 companies in order to avoid U.S. withholding tax liability on earnings of U.S. subsidiaries that are distributed abroad.

The proposal would prevent taxpayers from avoiding withholding tax through manipulations of these rules.

Modify foreign office material participation exception.—In the case of a sale of inventory property that is attributable to a nonresident's office or other fixed place of business within the United States, the sales income is generally treated as U.S. source. The income is treated as foreign source, however, if the inventory is sold for use, disposition, or consumption outside the United States and the nonresident's foreign office or other fixed place of business materially participates in the sale. Income that is treated as foreign source under this rule is not treated as effectively connected with a U.S. trade or business and is not subject to U.S. tax. The proposal would provide that the foreign source exception shall apply only if an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income.

Stop abuses of CFC exception under section 833.—A foreign corporation is subject to a four-percent tax on its United States source gross transportation income. The tax will not apply if the corporation is organized in a country (an "exemption country") that grants an equivalent tax exemption to U.S. shipping companies or is a controlled foreign corporation (the "CFC exception"). The premise for the CFC exception is that the U.S. shareholders of a CFC will be subject to current U.S. income taxation on their share of the foreign corporation's shipping income and, thus, the four-percent tax should not apply if the corporation is organized in an exemption country. Residents of non-exemption countries, however, can achieve CFC status for their shipping companies simply by owning the corporations through U.S. partnerships. The proposal would stop this abuse by narrowing the CFC exception.

Replace sales-source rules with activity-based rules.—If inventory is manufactured in the United States and sold abroad, Treasury regulations provide that 50 percent of the income from such sales is treated as earned by production activities and 50 percent by sales activities. The income from the production activities is sourced on the basis of the location of assets held or used to produce the income. The income from the sales activity (the remaining 50 percent) is sourced based on where title to the inventory transfers. If inventory is purchased in the United States and sold abroad, 100 percent of the sales income generally is deemed to be foreign source. These rules generally produce more foreign source income for Unites States tax purposes than is subject to foreign tax and thereby allow U.S. exporters that operate in high-tax foreign countries to credit tax in excess of the U.S. rate against their U.S. tax liability. The proposal would require that the allocation between production activities and sales activities be based on actual economic activity.

Modify rules relating to foreign oil and gas extraction income.—To be eligible for the U.S. foreign tax credit, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of the label the foreign government attaches to it. Current law recognizes the distinction between creditable taxes and non-creditable payments for specific economic benefit but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax. The proposal would treat as taxes payments by a dual-capacity taxpayer to a foreign country that would otherwise qualify as income taxes or "in lieu of" taxes, only if there is a "generally applicable income tax" in that country. Where the foreign country does generally impose an income tax, as under present law, credits would be allowed up to the level of taxation that would be imposed under that general tax, so long as the tax satisfies the new statutory definition of a "generally applicable income tax." The proposal also would create a new foreign tax credit basket for foreign oil and gas income.

MISCELLANEOUS REVENUE PROPOSALS

The President's budget also includes miscellaneous revenue proposals, many of which were proposed in prior budgets. Some of these proposals are: (1) taxing the investment income of trade associations, (2) the repeal of the percentage depletion for non-fuel minerals mined on Federal lands, (3) the reinstatement of the oil spill excise tax, with an increase in the full funding limitation from $1 billion to $5 billion, (4) a modification of the FUTA deposit requirement, (5) simplification of the foster child definition for purposes of the earned income tax credit, (6) an excise tax on the purchase of structured settlements, (7) several proposals to improve compliance, (8) repeal of the de minimis rental income rule, and (9) certain pension and compensation-related provisions. The budget proposals also include various other provisions that affect receipts. These are the reinstatement of the environmental tax imposed on corporate taxable income ($2.7 billion), reinstatement of the Superfund excise taxes ($3.8 billion), and receipts from tobacco legislation ($34.5 billion). The budget also converts a portion of the aviation excise taxes into cost-based user fees and replaces the Harbor Maintenance Tax with a user fee.

In conclusion, Mr. Chairman and Mr. Rangel, and members of this committee, the Administration looks forward to working with you as you examine our proposals. We want to thank you for your comments about our corporate tax shelter proposals, and your willingness to listen.

Chairman ARCHER. Mr. Lubick, thank you for condensing the recommendations for tax changes. Had you gone into detail on all of them, you probably would have consumed the better part of the day, and maybe not even then have completed all of them.

I couldn't help but think as I listened to you that you have portrayed exactly why I think we have to abolish the income tax. We have an endless stream of efforts that come forward every year to close quote "loopholes," to find some way to make the tax clearer while adding many additional complications. It seems like every additional complication that we add creates the need for more complications as the private sector's brilliant and creative minds go to work on all the complexities.

So I regret that today is not the day that we are going to mark up a bill to abolish the income tax.

Mr. LUBICK. Well, I had hoped I would not lead you to that conclusion, Mr. Chairman.

Chairman ARCHER. Unfortunately, this is not the day. So we do have to discuss the complexities of what you have recommended, and the areas where we believe you are on the right track. There are a few proposals in your budget recommendations, and we certainly want to work with you to see that the laws are changed.

You are right, probably, about 5 percent of the time, we are glad to work with you within that framework.

Mr. LUBICK. That's one of the best batting averages I have had in my experience here. [Laughter.]

Chairman ARCHER. I want the Members to have plenty of time to inquire, and I'm going to try to keep mine as brief as possible. There are a couple of things I did want to ask you.

Does the administration have a fundamental objection to broad-based tax relief?

Mr. LUBICK. No, Mr. Chairman. Actually, we think if the relief is framed, first of all, that it be fiscally responsible, second that it be fair and equitable, that it be—that it not complicate the Code—we are certainly responsive to that. There are, however, a number of constraints we have. We think it is important at the start to deal with the problem of putting Social Security on a sound basis. I know you have endorsed that concept as well.

And when that is done, there are other very, very pressing needs to be addressed both in terms of retirement, encouraging savings for retirement by that part of our population that is not adequately able to do it now. So that is why we have proposed that when that Social Security problem is solved that part of the surplus be used for that.

And ultimately, there are a host of very crying needs that should be addressed. You have enumerated a number of them. From time to time, you have talked about the alternative minimum tax, but all in all, I think there certainly is room at the proper time, if done in the proper way, to have general relief.

Chairman ARCHER. Within the constraints, of course, which have been stated before this Committee by the representatives of the administration as to the overall budget. Presently, you have opted for targeted tax cuts rather than any sort of broad-based tax relief. And so I just wanted to be sure that you didn't have some inherent objection to broad-based tax relief.

Mr. LUBICK. Well, certainly not. But at the present time we are operating under budget constraints as you are more aware than I. If there are particular pressing needs, basically the only way that they can be addressed is through the tax system today. The question of spending programs to deal with these problems is really practically out of the question. And so there has been this great pressure over the last decade to use the tax system, which, as you have pointed out, has put a strain on it.

At this time, in the areas I have outlined, where we have addressed it, we have come to the conclusion that there are indeed special exigencies that would require some sort of action. And that is why we proposed to enact them on a fully funded basis. I think you would doubtless agree that your general abhorrence of tax increases does not extend to a situation where deficiencies in the Code have to be rectified, things that you never intended should be cleaned up, and that, of course, will in effect raise revenue from those persons that were taking undue advantage of the Code.

So you are not proposing an enactment of a static situation. So we have tried to identify those situations in providing the funding for the targeted tax relief that we think is appropriate in a way that would not do violence to your general predilection, which we share, against tax increases.

We haven't, for example, proposed general changes, increases in rates. We haven't proposed restrictions, or cutbacks on longstanding deductions or credits or exclusions. You have pointed out that this involves a significant number of proposals, each of which is, in terms of the universe of taxation, somewhat not cosmic. But I think if we get to a situation where we have dealt with the most pressing problems, then it is time to consider broader and more expensive changes in the tax system as well as the new rules of the game that are going to operate both as to spending and taxation when we are over those hurdles.

Chairman ARCHER. Mr. Lubick, I am trying to keep my time as short as possible to permit the other Members to inquire. I asked one question and it has taken quite a long time to pursue that question.

Suffice it to say that within the constraints that you mention, you opted in your budget for targeted tax relief. This means that the administration has decided where resources should be put rather than broad-based tax relief, where the taxpayers would make the decision as to what they thought the priorities were. That is clear in your budget.

Let me get back to the next issue to which you lead me. Your budget does not provide any net tax relief. That is apparent on the face of it.

Mr. LUBICK. Although we have a proposal after the——

Chairman ARCHER. No. But in your budget there is no net tax relief.

Mr. LUBICK. You are correct.

Chairman ARCHER. Rather it raises on a net basis $89 billion in net revenues, irrespective of how you describe them. And yet, it is also a fact that in your budget and under current law, the Federal Government is taxing a higher percentage of GDP than in peacetime history for this country.

People are paying those taxes. The burden of those taxes must be borne by increased prices of goods and services in this country. They have to be recovered. And it is built into every single product and service that we buy.

I am concerned about whether you view this high level of taxes with any kind of alarm. I am particularly curious as to why your budget proposes an $89 billion net increase in tax revenues at a time that we are projecting surpluses. Do you believe that the level of taxes as a percentage of GDP is too low?

Do you really think that the highest peacetime level of taxes in this country's history is too low and therefore you need another $89 billion of new revenues?

Mr. LUBICK. Mr. Chairman, I believe it is fair to say that the amount of revenues taken, and I deal with the Federal Government only, as we have no control over the States or localities, but you are correct that as calculated, the percentage of revenue over GDP is about 20.6 percent.

Chairman ARCHER. Almost 21 percent at the Federal level.

Mr. LUBICK. However, within a couple of years, it slated to decline to 20 percent because of provisions that have already been enacted. But there are several aspects to this.

First of all——

Chairman ARCHER. OK, but you want to increase that percentage before it shows any decline? You don't think that is enough? You think that the revenue percentage is too low so you want to increase it by $89 billion?

Mr. LUBICK. Well, one of the things, of course, that I think if you are talking about our wish list, you do have to take into account the reductions that we are proposing following the Social Security, which I think would, in great measure, if not entirely, offset that. So I don't think there is anything inherent in our proposals that calls for putting a greater burden of taxation at the Federal level on the American people.

In point of fact, we do not. So that the long-range proposal, taking into account everything that we have proposed, would be the other way around.

But I think it should be noted that for most Americans, the level of taxation at the present time is the lowest it has been in long-term memory. For a median-income family of four, the Federal income plus payroll tax burden, that is including both the employer and the employee shares of the payroll tax, is lower today than at any time in the past 21 years.

The Federal income tax burden alone for the median-income is lower than at any time in the past 30 years.

Chairman ARCHER. Yes, I am aware of that claim, and it has been presented to us on several occasions by representatives of the administration. Yet it does not take into account that the Federal tax burden is hidden in the price of all our goods and services.

And the poor pay the most. They just don't know it.

Sadly, I hear you saying, as a representative of the administration, that the highest peacetime tax take in history, as a percent of GDP, which must be borne by all Americans is still not high enough. Furthermore, you have to increase it on a net basis of $89 billion. I just find that difficult to come to grips with.

But I have used up more than my time. So I recognize Mr. Crane for inquiry.

Mr. CRANE. Thank you very much, Mr. Chairman. I'm having a hearing in April on Customs, including user fees, but I have a couple of questions for you today. In the President's budget, he has proposed increasing the passenger processing fee paid by travelers arriving by commercial aircraft and vessels from $5 to $6.40 and removing exemptions from the fee.

According to the administration, this would partially offset Customs costs associated with processing air and sea passengers, but many people believe that the $5 fee is already too high and is more than Customs' actual costs in processing arriving travelers. Can you explain the basis for the increased fee?

Mr. LUBICK. Well, it is my understanding, Mr. Crane, that this is essentially a user fee, which is designed to recover the full costs of the services provided by the U.S. Customs Service and to recover it on a more uniform basis. It is my understanding that the $5 fee currently does not recover the full costs. The $6.40 is the amount that would cover all services that should be subject to the fee. And even that does not cover the administrative cost. This is based on our calculation of reimbursement for the costs of direct services for a clearly identifiable set of beneficiaries.

That is the definition of a user fee as opposed to a tax. It is designed to impose upon those who clearly, identifiably benefiting from the service and who should bear the cost rather than the taxpayers as a whole.

Mr. CRANE. So you are saying it is absolutely a user fee only and it is because of the cost that you have defined?

Mr. LUBICK. That is my understanding. I am not prepared to give you an accountant's eye view of it, but I believe that the Customs Service will be able to substantiate that.

Mr. CRANE. Well, may I ask of you then, could you put something in writing for me just to verify the position that you have taken on that one.

Second question. The President has proposed charging an access fee for the use of Customs' automated systems to offset the cost of modernizing Customs automation. The trade industry believes that it has been paying for Customs modernization automation in other user fees, the merchandise, rather, processing fees and believes that the assessment of an access fee is excessive and should not be borne by the industry.

How will the fee be set, and will this be applied to the use of Customs automation for merchandise originating from NAFTA countries?

Mr. LUBICK. Mr. Crane, again I think, this was designed to cover the investment that the Customs Service has to make to install its newly automated system. The current system is over 15 years old, has suffered many brownouts and breakdowns. The estimated cost of the investment is about a billion dollars over the next 4 years, and the fees will only recover a part of these costs, about a $160 million a year, or about $640 million over the next 4 years. The remaining costs we hope to recover internally through savings. So it is the same basis.

Mr. CRANE. Thank you. I yield back the balance of my time.

Chairman ARCHER. Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman. Mr. Secretary, Forbes magazine in December, not normally a major critic of the corporate community in America, as I'm sure you are aware, ran a cover story on tax-shelter hustlers, pointing out that respectable accountants are peddling dicey corporate tax loopholes.

I wanted to inquire of you concerning how serious a problem this is.

Mr. LUBICK. Well I have stated how serious we think it is—very serious. Mr. Talisman, who is accompanying today has been spending virtually full time in the preparation of an analysis of this subject, which we will release in the very near future, when it is completed. And perhaps he wants to address his view on the seriousness of it because he has been down there in the foxholes. I don't know what has been running over his feet.

Mr. DOGGETT. That would be fine.

Mr. TALISMAN. Mr. Doggett, we believe it is a very serious problem for the reasons articulated in Don's oral testimony and written testimony. One, it undermines the integrity of the system when products are being promoted to large corporations merely to avoid tax with no economic substance.

Second, it will cause other taxpayers to view the system as unfair, which obviously may undermine the voluntary compliance system. Also, we think that the resource allocation both from the outside practitioners and others who are promoting these is not a wise use, a productive use of resources.

Mr. DOGGETT. By resources, you mean basically that some of the brightest minds in the country devote their every waking hour to trying to avoid paying the taxes that ordinary taxpayers have to pay.

Mr. TALISMAN. Correct. And also because we at the Treasury and Internal Revenue Service spend a great deal of resources tracking down these shelters and then having to shut them down on an ex post basis, and litigating cases for many years involving tax shelters.

Mr. DOGGETT. So the taxpayer who doesn't get to take advantage of these high-flying schemes, pays for it twice by having to pay taxes that someone else is not paying and then by having to pay for the enforcement resources necessary to try to ferret out these schemes?

Mr. TALISMAN. That is correct.

Mr. DOGGETT. Now the Forbes magazine article suggested that the size of the dimensions of this problem may exceed $10 billion in tax a year. Is that a fair estimate?

Mr. TALISMAN. Well, the answer to your question is, is that it is very difficult to put a firm estimate on the amount of revenue that is being lost to the system.

However, there have been several shelters in recent memory, for example, liquidating REITs or the step-down preferred transaction, where the size of those transactions over the course of a 10-year period were in the multibillions of dollars.

As a result, you know, a $10 billion estimate seems like it would be in the ballpark, but again it is very difficult to put an exact number on——

Mr. LUBICK. This whole operation, Mr. Doggett, is clandestine. They operate under confidentiality arrangements, whether explicit or implicit, so it is——

Mr. DOGGETT. If my time permits, I want to explore that also, but I think the first and most important point is that the dimensions of this problem—it is a very sizable number, whether it is $10 billion or $9 billion or $20 billion, we are talking about billions of dollars in what even Forbes magazine described as tax schemes never intended by this Congress.

Now I gather by some of the comments that have already been made in the Committee that there are some who feel that all tax cuts are created equal and that all tax increases are created equal. But with $10 billion a year, you could a long way to meeting the child-care needs through a child-care tax credit to a working mom. Couldn't you?

In terms of the costs of these proposals?

Mr. TALISMAN. That is right.

Mr. DOGGETT. So that for the working mother or the person that needs long-term care or the person who needs educational assistance, we would be giving them a tax cut. Some may ridicule that and say that we ought to treat everybody the same, but with the money that we would be bringing into the treasury by addressing these schemes, we would have the capability to meet some of the real needs that are out there for tax cuts for working moms or those who have long-term care needs, or some of the other measures that you have before the Committee?

Mr. TALISMAN. The package of raisers on corporate tax shelters raises, according to our figures, around $7.2 billion. So, yes, that would——

Mr. DOGGETT. And that would pay for the child-care tax credit, would it not?

Mr. TALISMAN. That is correct. Yes.

Mr. DOGGETT. And, has the use of contingency fees by some of these accounting firms become a prevalent practice in these tax schemes where they earn more if they avoid taxes?

Mr. TALISMAN. There are a number of devices that are used to protect the corporate participant, including contingent fees, rescission agreements, unwind clauses, and, even now, the sale of insurance.

Mr. DOGGETT. I look forward to your report on this very serious problem. Thank you, Mr. Chairman.

Chairman ARCHER. I would simply suggest to the gentleman the $7.5 billion has already been consumed by the administration for its other tax reductions, and so he will have to look elsewhere for the desirable things that he wants to do in the Tax Code.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. Mr. Lubick, one of the Treasury Department revenue proposals would change the control test that is applicable for tax-free incorporations for distributions and also for reorganizations. The effective date of the proposal is recommended by the Treasury Department for transactions occurring on or after the date of enactment of the proposal.

So, what I would like to ask you, am I correct in assuming that you would ensure that companies that have filed ruling requests with the IRS before the effective date of enactment would be grandfathered from any proposed changes?

Mr. LUBICK. We generally defer to the Committee's wisdom on appropriate transition rules to prevent retroactive unfairness. And this would be a situation where we would be glad to work with you and give you our ideas. But we think we are concerned with establishing the principle first and foremost, which we think is correct for the future. And to the extent persons happen to be caught in the web in a way that they have no opportunity to extricate themselves, I think the Committee has traditionally given fairness relief, and we certainly concur that is your province.

Ms. DUNN. You would let——

Mr. LUBICK. We concur that it is your appropriate province to do that.

Ms. DUNN. Good. Thank you.

Chairman ARCHER. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Secretary, the administration is proposing making the brownfields expensing provisions permanent.

Mr. LUBICK. Yes, sir.

Mr. COYNE. Regarding the legislation we passed in 1997. I wonder if you could tell us how the brownfields expensing provision is working so far and how it is being used?

Mr. LUBICK. Well, we think it has worked very well. We should have some statistics that show a very large impact in cleaning up and making more livable communities inhabited by low-income and less fortunate persons.

So far, I know that least 25 sites have been certified and there has been significant benefit there. And I'm not quite sure how many are in the process of achieving that status, but it is—I would judge it as very significant success.

Mr. COYNE. Have you any idea of who is using the provisions?

Mr. LUBICK. Well, the limitation is to census tracts that have a poverty rate of 20-percent or more, or other census tracts with a small population under 2,000 where 75 percent of it is zoned for industrial or commercial use and is contiguous to census tracts with a 20 percent poverty rate or more, or the areas designated as Federal empowerment zones or enterprise zones or there are 76 EPA brownfields pilots that were announced prior to 1997. So those areas are eligible as well. They are both urban and rural. So is has widespread application to those areas where the need for renewal is most important.

Mr. COYNE. Is the administration making any other recommendations besides making it permanent in the Code during this budget process? Are there any other recommendations on that list?

Mr. LUBICK. With respect to these areas?

Mr. COYNE. Right.

Mr. LUBICK. Yes, we do. We have, in particular, our new markets credit, which is intended to fund community development entities that are providing funds for private enterprise to go into this sort of area to carry on active businesses. And that in itself should improve the business. We have a proposal for our Better American Bonds, which is a tax credit modeled on the QZAB, the Qualified Zone Academy Bonds, the bonds that were previously adopted by this Committee to provide bonds to finance environmental improvement, which does not normally generate revenue to pay off the bonds. So this tax credit will help communities issue those sort of bonds.

We have some extension of enterprise and empowerment zones. So there are a number of other things in the budget that are addressing needs in these areas, including the extension of the work-opportunity credit and the welfare-to-work credits to help residents of those districts.

Mr. COYNE. OK. Thank you. The administration's budget request includes a proposal to reduce the deduction for interest on borrowing unrelated to life insurance, and I wonder if you could discuss the rationale for that proposed change?

Mr. TALISMAN. In 1996, Congress passed legislation to restrict direct borrowing against life insurance policies. And then in 1997, Congress further restricted the use of COLI, corporate-owned life insurance, products with respect to nonemployees, where you are borrowing against life insurance contracts, for example, on homeowners, and so forth. This proposal extends that principle, which is the tax arbitrage that results from use of tax-exempt interest when combined with inside buildup of life insurance.

Where the borrowing against the life insurance is not directly traceable to the life insurance contract, but is in effect, leveraging the life insurance contract. So that it would again prorate your interest deduction and disallow an interest deduction consistent with the changes that were made in 1996 and 1997.

Mr. COYNE. So are you generally characterizing that as a tax shelter?

Mr. TALISMAN. We are characterizing that as a tax shelter. Yes, we are, because it provides arbitrage benefits that can be used to shelter other income.

Mr. COYNE. In the past, hasn't it been used for very legitimate reasons?

Mr. TALISMAN. Well, when you say was it used for legitimate reasons, the tax benefits can be dedicated to very legitimate reasons. For example, retirement benefits, and so forth.

However, the arbitrage is not condoned by the Code and in fact it would be inconsistent with what Congress has done in 1996 and 1997.

Mr. COYNE. Thank you.

Chairman ARCHER. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. Mr. Secretary, good to see you again.

Mr. LUBICK. You too, Mr. Weller.

Mr. WELLER. And I have enjoyed listening to the statistics going back and forth on the tax burden, and I will share one too, I guess. It is my understanding that about the average family's income today, at least the average family in Illinois, goes to government at the State and local level. And of that, my understanding is, probably what is the highest tax burden on Illinois families in the history of our country. What is it almost 21 percent of our gross domestic product today goes to the Federal Government alone?

So that is my statistic I would like to toss out about how high taxes are, and the tax burden on Americans.

Mr. LUBICK. May I differ with that statistic?

Mr. WELLER. Well, perhaps when you respond to my question here. You know, when I was back home over the last weekend, you know, you always run into folks and actually read the fine print, and they ask questions of me. They say, you know, in the President's budget, why in the President's budget in a time of surplus, when we have all this extra money, do we need $176 billion in tax increases? And why in this time of surplus does the President propose spending $250 billion in Social Security trust funds for other purposes?

And I am pretty pleased with the decision by our leadership to put a stop that type of practice that the President wants to continue.

I also note in your budget that you continue to advocate targeted tax cuts, and some might describe a targeted tax cut as targeted so very few benefit and they get very little. And the issue of brownfields tax incentives was mentioned just a few moments ago, and I am, of course, a strong advocate of that, I often wonder, don't middle-class communities—I think middle-class communities—the need environmental cleanup as well. I can think of towns like New Lenox and Morris and LaSalle-Peru that can use that environmental tax incentive which is targeted so much that they are denied that opportunity to clean up the environment.

What I want to focus on here, particularly, is in your budget, you are asking essentially for some blanket authority to address what you call tax avoidance schemes. And I think I am one of those who believes that when Congress writes a law, your job is to follow the law and, of course, collect those taxes. That is our intent.

But last year, when the Ways and Means Committee and the Congress passed what I feel is one of our greatest accomplishments, and that is the IRS reform, we were addressing, as part of IRS reform, an area where we felt that IRS was doing something we did not want the IRS and the Department of Treasury to do. And that is the issue of meal taxes in the hospitality industry.

And in the IRS reform bill there was section 5002, which gave a protection to the working moms, the cocktail waitresses, the coat-check people, the people who provide hospitality at various employers, including almost 4,000 employees of the south suburbs that I represent.

It is interesting, these individuals make an average of about $16,000 a year in the hospitality industry because of the nature of their job and demands of their job, they are called upon to be around all the time. They may have to wear certain types of uniforms. And so they are provided meals, maybe a hot dog or something by their employer to make it convenient for them.

And for some reason, you insist on taxing them on that hot dog. Now, the IRS reform legislation made it very clear the intent of this Congress was—is that we do not want you to tax that working mom, probably raising some kids—she is probably a single mother who is a waitress or cocktail waitress or working in the checkout, or that busboy, for example.

But it is my understanding that you are continuing to come back and insisting on taxing that employee of the hospitality industry. As I point out, 4,000 people in the district I represent. I just don't understand why you are ignoring the intent of Congress and legislation that the President signed.

I was wondering if you can respond to that and explain why you are so insistent on taxing the hot dog and the meal that is provided to these working moms in the hospitality industry?

Mr. LUBICK. We do have an overall problem, Mr. Weller, which is that if we have a general standard that meals furnished by an employer to an employee are outside of the tax base, that compensation will immediately respond, so that every worker in the country will be getting a little-bit reduced salary and some meals, which will be—so, the general principle is difficult. Now there are exceptions where they have been longstanding exceptions in the Internal Revenue Code.

Mr. WELLER. Mr. Secretary, just quickly reclaiming my time, the intent of Congress—we put a safe harbor in the law in section 5002 of the IRS reform legislation, which your President and my President signed into law. We made it very clear that you should not be taxing the cocktail waitress, the working mom who is given a hotdog as part of—to help her be able to be at work. Now that was the intent of Congress, and yet you continue to come back and insist on taxing this cocktail waitress and this busboy and those in the hospitality industry.

And I just don't understand why you ignore the intent of Congress, when we made it very clear that we want you to put a stop to taxing these individuals.

Chairman ARCHER. The gentleman's time has expired.

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Thank you, Mr. Lubick for your usual sturdy performance here. I appreciate your presence. The alternative minimum tax. The administration proposes to extend tax relief from the alternative minimum tax for tax relief for individuals for nonrefundable credits for 2 additional years, for this year and for next year. I am going to reintroduce in the next few days my bill from the last Congress to provide relief on a permanent basis.

As you know, Mr. Chairman, you were helpful last year on this issue. We discussed it. What is the administration's long-term position on this issue?

Mr. LUBICK. Well, as a long-term matter, Mr. Neal, it is, I think, abundantly clear that these credits, like so many other things that are under the individual tax, were never intended to be the sort of tax preference that the tax should apply to. Unfortunately, under the revenue scoring constraints that we operate under, those things which, I think virtually everybody agrees, ought to be changed have not been capable of being addressed on a permanent basis.

The problem is going to get continually worse, and we would hope that a way could be found to deal with this situation on a permanent basis. Not only the credits, but State and local taxes, personal exemptions, perhaps even the 15 percent can be considered a preference under the alternative minimum tax. That certainly was not the intent when the alternative minimum tax was first conceived. It was excessive use of tax preferences, and the problem awaits the will of people to devote the funds to that before the problem gets completely out of hand.

Mr. NEAL. Well, given revenue forecasts for the foreseeable future, does that provide us with an avenue for relief or potential for relief?

Mr. LUBICK. Well, I would hope so. There was a reference to the surplus. Of course, at the present time, the unified surplus depends upon the Social Security surplus. It depends upon using the funds that were dedicated to the Social Security Trust Fund for other purposes. If you didn't count Social Security, we would not be in surplus either this year or next year.

But, yes, I think Chairman Archer has been talking about this for some time, and I think quite correctly. And as such time—this is one of the big-ticket items of general relief that I think ultimately is appropriate.

Mr. NEAL. Thank you, Mr. Lubick, and I hope that we will have a chance with the Chairman and Members of the Committee to pursue this issue because I think we all acknowledge that we are reaching a critical juncture, and as time moves along, I think we cannot continue to repair this on a 1- or 2-year basis. We have to speak about a more permanent solution.

The second question I have is, since Mr. Weller mentioned the issue of tax avoidance, Mrs. Kennelly, as you know, last year, produced a fairly extensive bill that dealt with this whole question of hedge funds. And the administration's proposal seems to be a bit more narrow than the one that Mrs. Kennelly offered, which I intend to work on again this year, and about which I have been seeking information and advice.

Could you give us an explanation about the effective date and how you intend to treat this issue in coming months?

Mr. Talisman?

Mr. TALISMAN. I think, Mr. Neal, when you said it was more narrow, I think you may mean that we limited it to partnerships as opposed to other pass-through entities. Again, we narrowly tailored our proposal to focus on total return swaps on partnership interest because that was the way we understood the transactions were being done. We realize that it may be possible, theoretically possible, to achieve conversion and deferral using total return swaps on other pass-through structures, such as REITs and PFICs, passive foreign investment companies. We are currently looking at that issue.

We understand that PFICs are actually already addressed by the law, but we are also looking at that issue as well. We would certainly like to work with you and your staff in addressing this issue.

Mr. NEAL. My intention is to proceed with a version of the Kennelly bill, and I hope that we will be able to find some common ground as this moves along. I do think this general area has the potential for serious problems down the road.

Thanks, Mr. Chairman.

Chairman ARCHER. I thank the gentleman for his line of inquiry. I have been disturbed for a long time about the alternative minimum tax. Clearly now the problem is exacerbated by the new child credit and the Hope scholarship credit. Even if you eliminate those items from the alternative minimum tax, the tax still hits the personal exemption. Currently, many people are not entitled to take a personal exemption without paying a tax on it. The personal exemption has been an inherent, fundamental part of the income tax law.

Yet this pernicious alternative minimum tax comes back in when you have to reformulate all your income. You have done your regular tax return, but then you have to compute and add back in your personal exemption and pay a tax on it.

Mr. Lubick, why can't we just abolish the personal alternative minimum tax? Why have it in the Code?

Mr. LUBICK. There are a few items, but a very few items, that probably may be justified to be under it. Most of the other preferences that were there originally, have been taken care of.

Chairman ARCHER. Should the personal exemption be under it?

Mr. LUBICK. It certainly shouldn't be, nor should the standard deduction, nor should the deduction for State and local taxes, nor should the deduction for medical expenses.

Chairman ARCHER. Well, you have named all of them. Let's just get rid of it. What else is left?

Mr. LUBICK. Well, there are a few minor things like stock options——

Chairman ARCHER. Yes, but they don't amount to a hill of beans. I would like for my friend from Massachusetts to join with me to abolish the personal alternative minimum tax. We are facing a situation where a married couple, earning $59,000, taking the standard deduction only, will be under the minimum tax in the next century.

I mean, this is ridiculous. The gentleman set me off on this. This is a cause celebre for me. I apologize to the other Members of the Committee for taking the time.

Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Chairman. To the Secretary, you know, in regards to the Chairman's comments, wouldn't you agree that the alternative minimum tax is outside the boundaries it was originally intended to address.

Mr. LUBICK. I think I stated it in my answer to Mr. Neal that certainly is our opinion in the Treasury Department and the question is that it becomes expensive and then you have to find some pay-for under the existing rules, and the problem is that because there is an exemption under the alternative minimum tax that was adopted originally that was not indexed, the exemption took most people out of it.

Now the value of that exemption compared to a person's income has been depreciating on an annual basis, and so each year that you delay in doing this, it becomes more expensive to do it.

So it is a problem that I think, on the merits, we can achieve virtual unanimity.

Mr. MCINNIS. I guess a couple of other points I should ask. First of all, for my colleagues, well, the contingency fee issue that was discussed with some accountants. I went to law school, and I should also point out that trial lawyers collect contingency fees handling tax matters as well. So it is not exclusive to a set of hard-working accountants.

Mr. TALISMAN. The proposal would not impose any restrictions on——

Mr. MCINNIS. I understand that. I am just clarifying a comment, so we know the trial lawyers are in this pool of money as well.

I guess, when we talk about these shelters, the legitimacy of those no longer become a concern if we were to reform the Tax Code and put in a consumption tax.

It would seem to me that the ultimate goal is fundamental reform of the system and then we can eliminate all of the questions of this issue.

But let me go on and ask, I'm a little unclear, Mr. Secretary, tell me again how you draw the determination between tax shelters that are outside the original intent and are misapplying the intent of the law versus directives to the Treasury Department to find revenue raisers? And do you have—the second question is, do you have incorporated in these tax shelters, shelters that still live within the boundaries of their original intentions but are a susceptible target for revenue-raising?

Mr. LUBICK. The are expressly taken out. Where Congress intended a provision to operate like a tax shelter, for example, the low-income housing credit, they are expressly excluded. We are dealing with the unintended shelters.

Mr. MCINNIS. So there are no shelters in there that are acting within their boundaries but placed in there to find revenue.

Mr. LUBICK. If the result achieved is that which Congress was trying to get at, as is true of many special preferences which have the effect of sheltering other income, this provision explicitly does not deal with those. It imposes no restrictions. It couldn't. It couldn't. They are permitted. If they are permitted under the law—anything that is permitted under the law is not a tax shelter by our definition.

Mr. MCINNIS. OK. And to determine that, I assume you look at legislative history. What are the combination of factors you use to apply to a specific tax shelter where it is somewhat gray as to whether the law allows it or not?

I mean, if the law didn't allow it, you could go back and audit and recover the funds. But here there is an area where you are saying, well, maybe they are within the letter of the law but they are not within the intent of the law.

Mr. TALISMAN. The definition of tax shelter has two components. One is that the pretax profit is insignificant relative to the aftertax benefit. That is an articulation that actually is in the judicial doctrines, including the *Shelton* case and the recent *ACM* case. That clearly contemplated by the Code to which Mr. Lubick was referring to is already in the definition of corporate tax shelter for purposes of section 6662. So that articulation is already in the regulations, the section 6662 that items that are clearly contemplated by the Code do not constitute a tax shelter.

So that has been a definitional rule that has been in existence for many years.

Mr. MCINNIS. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman, and my question was really touched on by Mr. McInnis and also to some degree Mr. Doggett. You said in response to a question by Mr. Doggett you have a report out about the abuse of the system as it relates to these—when could we expect that?

Mr. LUBICK. Mr. Talisman is the guy who is in charge of it, so I think I will let him answer the question so I don't go under the gun.

Mr. TALISMAN. We are hopeful to have it out within, I would say, a month. We are working very hard on it, but we want to make sure that it is as complete as possible.

Mr. TANNER. And in that report, you will, I suppose, define for us further what you consider——

Mr. TALISMAN. And we will also, I hope, take into account many of the recommendations that we will see based on the testimony today so that we can comment on those as well.

Mr. LUBICK. We have been talking with practitioners, with companies, and we continue to have our doors open to people to help us make sure we don't make any mistakes.

Mr. TANNER. Well, I am sure you understand there is concern that definition and so on as it relates to achieving a solution to the problems we are talking about here in that, frankly, a minimization of one's tax liability is a completely legitimate business purpose.

Mr. LUBICK. That is legitimate. Right.

Mr. TANNER. And I think what Mr. McInnis was talking about, we are all concerned about, the fairness of the Code and so forth. And to get at these schemes of course is something that we are all interested in. But there are certain, may we say, provisions of the Tax Code that are not black and white, and those instances, we would hate to see—because we will get the complaints—we would hate to see the service take a position with regard to, for example, good-faith exception, the substantial authority, those words, you have some proposal there is——

Mr. LUBICK. We believe in the definition of tax shelter that we have underdefined rather than overreached. We have tried to make sure we don't go too far. And we believe we are exactly within the Code as it is enacted or has been interpreted by courts for a long time.

Mr. TANNER. This will be addressed in your report?

Mr. LUBICK. Right.

Mr. TANNER. Good. We will look forward to it. Thank you.

Chairman ARCHER. Mrs. Johnson.

Mrs. JOHNSON of Connecticut. Thank you. And welcome, Mr. Lubick. I do find it quite remarkable that you are proposing $82 billion in tax increases when we have a surplus because taxes do even all come out of workers' pockets. You can call them corporate, but in the end they are paid by you and me and the next guy, either through product prices, lost wages, and so on.

I took a lot of heat last year, and this Committee took a lot of heat, for proposing $80 billion in tax cuts. And here you are, with a surplus, coming to us with $82 billion over 5 years in tax increases. So I just wonder why you thought it was necessary—and I would appreciate it if you would keep it short, because I do have specific questions as well—but why, when there is a surplus and when the surplus going out into other years is trillions, why?

Mr. LUBICK. Well, Mrs. Johnson, the package that we have talked about of initiatives and revenue-raisers is balanced. So we are dealing with some user fees in the aviation industry, which again is really not a tax but a question of those benefiting from the services——

Mrs. JOHNSON of Connecticut. The $82 billion, though, was only taxes, not user fees.

Mr. LUBICK. Pardon me?

Mrs. JOHNSON of Connecticut. The $82 billion was only taxes, not user fees. You are right, it is more money if you include both taxes and user fees.

Mr. LUBICK. No. I think what we are trying to do is recover from the users of the system the cost——

Mrs. JOHNSON of Connecticut. Right. But that is not in my $82 billion figure, as I understand it.

Mr. LUBICK. And I think the other item involves the excise tax on tobacco, which is in the budget, but I think——

Mrs. JOHNSON of Connecticut. Are you really saying though when you say balanced, that our budget is balanced, that you proposed $82 billion in tax increases plus user-fee increases in order to fund the new spending in the budget?

Yes. The answer is simply yes. I mean, let's not belabor this. We all know that to stay within the caps you would have had to free spending and cut $17 billion. And to work within the balanced budget you had to pay for new spending and so we have $82 billion in proposals to increase taxes to fund new spending. It is simple. I don't want to belabor it, I just want it clear.

Mr. LUBICK. But I think you are not taking into account the proposal involving USA Accounts, which is a tax reduction of——

Mrs. JOHNSON of Connecticut. Sure. And that is one of the new programs out there, and they all cost money, whether they cost money to the Tax Code or whether they cost money through appropriated dollars. But the fact is what you are doing is raising the money to pay for new programs. And one of them happens a very interesting and in some circumstances, a very desirable approach for savings.

Mr. LUBICK. It is a tax reduction. It seems to me it is a tax reduction.

Mrs. JOHNSON of Connecticut. Sure. It is. But the fact is you are raising taxes to fund it. So I just think we ought to be honest about this. To stay within the budget caps and within the budget deal, all the new spending that the President is talking about, whether it is long-term care assistance, whether it is education funding, whether it is construction grants, whatever it is, it is funded by this pot of $82 billion in tax increases and the additional fees. And the reason you have to do that is because you know and I know that to stay within the balanced budget he would have had to free spending and cut $17 billion in outlays.

So I just want that on the record. But I also want to say then—ask you, why have you chosen, first of all, when clearly if you are serious about your spending purposes, why have you chosen to fund them in part with 30 proposals that have been rejected by this Committee on a bipartisan basis, I think 2 years in a row but certainly the last time. And then, specifically, now how can you justify focusing and undoing something this Committee did, and it happened to be my amendment, just the last year, and then you do it in such a way that there is a kind of retroactive whiplash?

And I am referring to the change that you are making in the S corporations, the change in the S corporation law that we put in there explicitly to allow S corporations to develop ESOPs, employee stock ownership plans. And you specifically undo what we just did last year.

Mr. LUBICK. I think, Mrs. Johnson, there has been a lot of writing since that was adopted. And I think we have adhered to the objective that was sought at the time, which was to make sure that an ESOP, which is an S corporation shareholder, is not subject to double taxation. And the problem is that by exempting the ESOP from being taxed on its current share of subchapter S income, you are creating one gigantic tax shelter, which has been written about by the commentators as a tremendous opportunity.

Instead, what we have proposed to do, is to do what is the situation with respect every other S corporation shareholder. After the tax is paid currently that there is no tax at the corporate level, but there is a tax at one level currently with respect to all S-income.

Mrs. JOHNSON of Connecticut. I will be happy to work with you on this because I don't believe that is what you are doing, and I think what you are doing is so extremely complicated that no one in their right mind would try to go into this negative carry-forward business.

But as far as I am concerned, I doubt that you as a government person have ever been in a company that is doing open-book management. But it is way beyond continuous improvement. It is such a level of involvement in management decisionmaking on a weekly basis and creates the most absolutely incredible level of efficiency and effectiveness and teamwork that it absolutely blows your socks off.

And why those employees who are literally part of managing day-in and day-out, can't have an ESOP I cannot imagine.

And why, from Washington, we should get into double taxation and all this stuff. But I will be happy to look at the literature, but I am not going to sit quietly by while you reverse progress we made last year that is really in harmony with the most dynamic things happening in our entrepreneurial society.

My red light has been on. So, thank you.

Chairman ARCHER. The gentlelady's time has long since expired. [Laughter.]

Mrs. Thurman.

Mrs. THURMAN. However, Mr. Lubick, I want to echo Mrs. Johnson's words because that is where my questions were going to go to as well.

Mr. LUBICK. We will be glad to discuss with both of you the reasons why I think we can demonstrate that this maintains the incentive for the ESOP and maintains the incentive for it to be part of S, but at the same time produces a very equitable result which was intended from the beginning, when the S corporations were adopted in about 1958.

Mrs. THURMAN. However, when we talk about the form of a loophole, this has only been in the law for 15 months, which is what Mrs. Johnson said. I guess one of the questions I would like answered is, can you cite some of those abuses and/or could you give us some ideas of what maybe IRS has done in the enforcement of this so that we would not go into changing what was the incentive.

I think it was specifically put into law as an incentive for these corporations to work into employee-owned, which is very important to them.

The second thing that I might remind you is that there was a similar situation to this in the Senate last year, very similar to this proposal, if not exactly this proposal. And one that this whole Congress, Democrat, Republican, Independent, has made very clear. And we talked about it when we did the tax reform; it is complexity. This becomes very complex for these folks. It was actually reviewed by the Senate last year, and they threw out any of this change just because of the complexity of what could potentially happen on that.

I think the third issue is the retroactivity. We got enough grief in 1993 on retroactivity, and now we are looking at doing something again on this ESOP issue.

So I think we have some very serious questions.

I will say to you that I was pleased with the decision that you have made to listen to the testimony that is going to be given in this panel as we go through today. I think you are going to find out why some people find this very objectionable, why this has worked particularly in this area, some people that are actually in and doing these kinds of ESOPs and why this is so important.

So I really hope that you do live up to that and take into consideration what they say because I think they can add a lot of light to this issue.

Other than that, there are obviously several things in this budget that I really do like. Sometimes, as Mrs. Johnson said, we probably rejected many of these, but I think the priorities that have been set forth in the budget are the right ones for folks, whether it is the long-term care or child care, whatever. And I just hope there is a way that we can achieve these goals without being totally disruptive in this country.

Mr. LUBICK. Thank you.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. No questions.

Chairman ARCHER. Mr. Lubick, Mr. Talisman, thank you for your endurance. We appreciate your testimony, and you are free to stay as long as you want and listen to the other witnesses. Thank you.

Mr. TALISMAN. Thank you, Mr. Chairman.

Mr. LUBICK. We have a large group here of supporters, as you can see. At Treasury rates, we can afford to tie up the whole shop for an afternoon, but they are going to observe very carefully. Thank you.

[The prepared statement and attachment of Mr. English follows:]

Congress of the United States
House of Representatives
Washington, DC 20515

March 10, 1999

Statement and Letter to be Submitted for the Record
Full Committee Hearing on the Administration's Tax Provisions in the FY2000 Budget

Mr. Chairman, I would like to submit for the record a letter signed by state and local government organizations opposing the three proposed tax increases included in the Administration's budget which would significantly increase the borrowing costs for state and local governments. Although the Administration has stated that these proposed tax increases are targeted at corporations and P&C companies, the REAL burden will be borne by states and localities that borrow to finance school construction, highways, and other public projects.

Thank you.

Phil English
Member of Congress

American Association of Port Authorities (AAPA)
American Planning Association (APA)
American Public Gas Association (APGA)
Association of Local Housing Finance Agencies (ALHFA)
Association of Metropolitan Sewerage Agencies (AMSA)
Association of School Business Officials International (ASBO)
Council of Development Finance Agencies (CDFA)
Council of Infrastructure Financing Authorities (CIFA)
Council of State Governments (CSG)
Education Finance Council (EFC)
Government Finance Officers Association (GFOA)
International City/County Management Association (ICMA)
Municipal Treasurers' Association (MTA)
National Association of Counties (NACo)
National Association of Higher Educational Facilities Authority (NAHEFA)
National Association of State Auditors, Comptrollers and Treasurers (NASACT)
National Association of State Treasurers (NAST)
National Council of Health Facilities Finance Authorities (NCHFFA)
National Council of State Housing Agencies (NCSHA)
United States Conference of Mayors (USCM)

March 9, 1999

The Honorable Phil English
U.S. House of Representatives
1410 Longworth House Office Building
Washington, DC 20515

Dear Representative English:

The Clinton Administration's Fiscal Year 2000 federal budget includes three proposed tax increases that would significantly raise borrowing costs for state and local governments. The organizations listed above strongly oppose these tax increases and we urge Congress to leave them out of any tax legislation.

The proposals in question are referred to in the budget under the headings "Increase the proration percentage for property casualty (P&C) insurance companies," "Extend *pro rata* disallowance of tax-exempt interest expenses that applies to banks to all financial intermediaries" and "Require current accrual of market discount by accrual method taxpayers." Although these proposed tax increases are ostensibly targeted at corporations and P & C companies, the real burden of the new taxes would be borne by states and localities that borrow in the capital markets to finance schools, highways, public buildings, water and sewer systems and most of the nation's public infrastructure.

The first two provisions have been recycled from previous Administration budgets. The third proposal, requiring accrual of market discount, is a new provision. Last year, strong bipartisan Congressional opposition to increasing the proration and extending the *pro rata* disallowance resulted in twenty-eight Ways and Means Committee members writing to specifically oppose these back door tax increases on states and localities. We appreciate the fact that you did not support these provisions last year and we urge a similar position this year.

Increased Proration Percentage

Demand for municipal securities is dominated by three sectors: households, mutual funds, and property casualty companies. In the years 1994 through 1996, households decreased their holdings of municipal bonds by $145 billion. Mutual funds holdings increased by $2 billion. During this same period, net new investment in municipal securities by property casualty insurance companies increased by $29 billion. Over the past several years, P&C insurance companies have been the only major source of new demand for state and local government bonds. Without their investment, interest rates faced by states and localities would otherwise be significantly higher than they are today.

The Administration's proposal to increase P&C insurance companies' "proration percentage" would create a disincentive for P&C investment in state and local bonds. The proposal would significantly increase the current tax "hit" that P&C insurance companies experience when they buy municipal securities. The effect would be reduced investment in state and local bonds by P&C's and significantly higher interest costs to states and localities.

Pro Rata Disallowance

The other onerous proposed tax increase in the Administration's budget – the extension of the pro rata disallowance to all financial intermediaries – would also raise borrowing costs for state and localities by reducing demand for their securities. The pro rata disallowance would have three effects. First, by eliminating government-sponsored corporations from the municipal market, the proposal would significantly increase costs for issuers of state and local housing and student loan bonds. Second, by increasing the cost to municipal securities dealers of holding tax-exempt bonds in their inventories, the proposal would increase the cost to states and localities of issuing new bonds. Finally, by increasing the tax burden for leasing and finance companies that do business with governments, small communities in particularly will have a more difficult time accessing the capital markets to finance new capital equipment like school buses and technology equipment. An earlier version of this provision was proposed by the Administration in its FY 1997 and FY 1998 budgets, but was not included in any legislation sent to the President because of significant Congressional opposition.

Treatment of Market Discount

The Administration's FY 2000 budget includes a new revenue raiser related to the treatment of market discount on debt instruments, including municipals. Under current law, market discount is taxed as ordinary, taxable income, but tax liability on market discount is not incurred until a bond is sold or redeemed. Under the Administration's proposal, accrual taxpayers would be required to recognize and pay tax on the accretion of market discount annually. This proposal would greatly increase administrative complexity for taxpayers and would adversely affect demand for municipal bonds.

Capital investment in infrastructure and other public assets is a key element in the nation's continued economic growth and expansion. Indeed, one of the benefits of a balanced federal budget is lower interest rates and increased capital investment. These tax increases proposed by the Administration would increase borrowing costs for states and localities and discourage new investment. We urge you to oppose these proposals and to join us in seeking to ensure that they are not enacted into law.

Chairman ARCHER. Our next panel is Stefan Tucker, William Sinclaire, David Lifson, and Michael Olson. If you would come to the witness table, please.

[Pause for witnesses to come forward.]

The Chair encourages guests to leave the room quietly so that we may continue. We have a long list of witnesses yet to appear this afternoon.

Gentlemen, as usual, I would admonish you to attempt to keep your verbal testimony to within 5 minutes, and, without objection, your entire written statements will be printed in the record.

Mr. Tucker, will you lead off and will you identify yourself for the record and whom you represent and then proceed.

STATEMENT OF STEFAN F. TUCKER, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. TUCKER. Thank you, Mr. Chair. My name is Stefan F. Tucker, I am the chair of the section of taxation of the American Bar Association. I am appearing here today on behalf of the section of taxation and, with respect to one item, appearing here on behalf of the American Bar Association itself. We very much appreciate the opportunity to appear before you today. The section of taxation has a membership of 20,000 tax lawyers, and, with a broad-based and diverse group of tax lawyers, we are, in fact, the national representative of the legal profession with regard to tax matters.

First, I would like to point out that the tax section has been a firm advocate, day-in and day-out, of simplification. And we think that this tax bill does not represent simplification. We have already sent the letter dated February 26, Mr. Chairman, of which you were sent a copy, noting to the administration that we are very disappointed in the breadth of the proposal.

When I sit here with 70 pages of proposals, that clearly does not meet anybody's goal of simplification and lack of complexity. We think careful scrutiny has to be given to any of these proposals, and we think that, from our perspective, complexity really fosters noncompliance, whereas simplification enhances understanding and compliance.

And we are willing to continue to take that position.

We agree with you on one item, very clearly. And that is the alternative minimum tax is just something that ought to be eliminated on the personal basis. We think now is the time, when we are facing budget surpluses, for Congress to stand up and say this really counts, and we recognize there may be a cost, but you are going to have 9 million taxpayers who unexpectedly are going to go into the AMT over the next decade. We are seeing it on personal exemptions; we are seeing it on State and local income taxes; we are seeing it on the standard deduction; we are seeing it on a number of items that nobody ever thought about.

Now is the time to do it. If we let this continue to go on, it's is going to get worse; it is never going to get better. And the scoring is going to get continually worse. It will never get better.

And yet it is an item that will lead to the destruction, we believe, of the income tax system at some point.

We also believe strongly——

Chairman ARCHER. Mr. Tucker, then perhaps we should leave it in place. [Laughter.]

Mr. TUCKER. We may have different views on that as tax lawyers.

We also think that the phase-out concept is an item whose time has come and gone. And it is just another way of saying that we don't want to raise tax rates, so we are going to impact people with the phase-out of itemized deductions, or the phase-out of personal exemptions. We think it is about time to face reality.

It is probably strange for tax professionals, tax lawyers, to say "let's stop the undersided approach and just go straight up," but we think we ought to.

We are really here, most importantly, to talk about corporate tax shelters. And when I use the term "corporate tax shelter," please understand it is not just focused on corporations. It focuses equally as much on limited liability companies, partnerships, business trusts, and trusts. It is a very widespread situation.

And I will tell you that we at the tax section strongly share the concerns of the Treasury Department that the tax shelter problem is a real problem. From our perspective, we would urge that you do not heed those who say that there are no problems. Do not heed those that say that corporations pay enough taxes.

It has been noted already, up here, that the less the corporation pays, the more the individual pays. If we are going to reduce tax rates, let's reduce them at the individual level and let the corporations pay their fair share.

The problems are real. The problems are there. They are not self-correcting. It's a secretive and insidious methodology, and let's not ignore the Trojan horse—it's already in the gate. The promoters are sneaking out at night. Put them out in full daylight and let people see what it is. Let's look and see whether the emperor really has any clothes in these corporate tax shelters.

And our focus is disclosure, disclosure, disclosure. Put it out and let people look at it, and then determine whether or not it truly works.

We think that, on the tax shelters, there are four features: there is a discrepancy between book and tax treatment; there is little economic risk to the corporation; too often there is a "tax indifferent party" involved; and there is a broad-based marketing by the promoter, by counsel, and apparently sometimes by the staff of the taxpayer itself. And we think that penalties ought to be imposed on those levels.

And if someone comes up in front of you and says there are no problems, we would urge that what you do is say: Are you the purchaser of a product? Are you the marketer of a product? Are you or your clients the marketers of products? If they are, ask them to give you three or four, and then look at those, and then see if they fit within these criteria that we have.

Last, because our time is already short, I would urge you to look at the proposed income tax——

Chairman ARCHER. Because I interrupted, you may feel free to go on for another minute or so.

Mr. TUCKER. Thank you, sir. I really appreciate it.

What we would like to do, if I can, is point out that there are solutions. We really believe, first and foremost, that there ought to be additional reporting for tax shelters, and we would note that the taxpayer ought to be attaching to the return detailed explanations. The taxpayer ought to be giving descriptions of due diligence. Why is there such a difference between the due diligence done in a public offering and the due diligence that is done in a corporate tax shelter?

Why are there simplistic assumptions being made that nobody has to back up? What is needed is security and real enforcement. One is SEC enforcement on the public offering, and two is the penalties imposed upon the people: damages, liability for not doing the job right.

You don't want to just do this at the corporate level. You want to look at the promoter. And you want to look at the advisers. If everybody has risk, it is going to make a difference.

We think you should broaden the substantial understatement penalty to cover outside advisers, promoters, and tax-indifferent parties. And if those tax-indifferent parties are exempt organizations, and they are being used to inure to the benefit of private parties, maybe they are violating the rules that apply to exempt organizations.

We think you ought to focus on a real definition of large tax shelters. There is a 1997 tax provision that still hasn't had its definition yet. It was noted before, we are still awaiting it from Treasury. It's difficult, to come up with a definition. It ought to be done.

And Congress ought to say that there are existing enforcement tools at the audit level that can be supported with funding to look at this.

Last, on the taxation of investment income of trade associations, on behalf of the ABA itself, we know that a majority of the Members of the Ways and Means Committee have stated they do not believe that this is something that should be done.

We think that it is a big problem. It ought not to be done; there ought not to be a tax on investment income. You impose a tax here, you simply put the dollars into another source. It is going to be a wash. It is not anything that ought to be done at this point.

Thank you, sir.

[The prepared statement follows:]

Statement of Stefan F. Tucker, Chair, Section of Taxation, American Bar Association

Mr. Chairman and Members of the Committee:

My name is Stefan F. Tucker. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. Accordingly, except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

As you know, the ABA Tax Section is comprised of approximately 20,000 tax lawyers. As the largest and broadest-based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We advise individuals, trusts and estates, small businesses, exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section's members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

The Section appreciates the opportunity to appear before the Committee today to discuss certain proposals contained in President Clinton's budget for Fiscal Year 2000. Our testimony today will not include comments on each and every proposal in the President's budget. We do anticipate, however, that additional individual comments on various proposals will be submitted in the near future. In addition, individual members of the Tax Section would be pleased to provide assistance and comments to members of the Ways and Means Committee and to staff on any proposals you might identify.

Our general focus today will be the overall need for simplification of the tax code and the corresponding need to avoid additional complexity. In addition, we would like to comment on the various tax shelter proposals contained in the budget, as well as the proposal to tax the investment income of trade associations.

SIMPLIFICATION AND COMPLEXITY

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, we are on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.

Over the past two decades, the Code has become more and more complex, as Congress and various administrations have sought to address complicated issues, target various tax incentives and raise revenue without explicit rate increases. As the complexity of the Code has increased, so has the complexity of the regulations that the IRS and Treasury have issued interpreting the Code. Moreover, the sheer volume of tax law changes has made learning and understanding these new provisions even more difficult for taxpayers, tax practitioners and Service personnel alike.

Although, until recently, many of these changes have not affected the average taxpayer, the volume of changes has created the impression of instability, in that the Code is becoming perhaps too complicated for everyone. This takes a tremendous toll on taxpayer confidence, evidence of which can be found in the broad public support for the IRS restructuring legislation passed last year. This Committee often hears how our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Tax Section can attest to the widespread disaffection among taxpayers with the current Code. Their willingness, and their ability, to keep up with the pace and complexity of changes, is at a point beyond which it should not be pushed.

It now appears that many in Congress are interested in enacting tax reductions this year. Press accounts indicate that various options are being discussed. The Tax Section does not take a position with respect to the wisdom of tax reduction generally or any particular proposals. We do urge, however, that the members of this Committee keep simplification and avoidance of complexity uppermost in their minds as any tax reduction packages are fashioned. Tax relief can be delivered in ways that avoid new, complicated rules and that steer clear of phase-outs that act as hidden marginal rate increases. While such broad-based reductions may not have the cache' of new, more targeted provisions, they will avoid the layering of new complexity over old. To paraphrase Hippocrates, if Congress chooses to reduce taxes, we urge you to do no harm.

To this end, on behalf of the Tax Section, I recently sent to Secretary Rubin a letter expressing our disappointment that the President's budget proposes to add a multitude of new tax credits to the Federal income tax system. Our point in that letter was that, although each credit taken in isolation could be viewed as meritorious, that kind of micro-balancing inevitably leads to the type of tax system that is, in total, overly complex and undeserving of public respect. Particularly in light of the various, complicated provisions added by the 1997 tax act, Congress and the Administration must focus on the cumulative impact of *all* new provisions sought to be added. Only then can they resist the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay.

My letter to Secretary Rubin also urged that particularly close scrutiny be given to any proposals that include income phaseouts. These phaseouts have gained popularity in the last two decades, and are responsible for a significant amount of the complexity imposed on individual taxpayers. As noted previously, phaseouts create the effect of a marginal rate increase as a taxpayer's income moves through the phaseout range, and the effects of multiple phaseouts on the same taxpayer can create capricious results. Phaseouts also play a significant role in the creation of marriage tax "penalties," and add to the difficulty in addressing that set of issues. We urge you to resist their continued use in the enactment of additional tax incentives.

We do not claim to have all the answers. The Tax Section will continue, diligently, to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification requires hard choices and a willingness to embrace proposals that are often dull and without passionate political constituencies. Simplification may not garner political capital or headlines, but it is crucial. Complexity fosters non-compliance; simplification enhances understanding and compliance.

To date, simplification has not achieved the commitment that we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge the Ways and Means Committee to adjust this balance. Without a commitment on the part of the members of this Committee to eliminate old and avoid new complexity, the trend will not be reversed. Members of the Ways and Means Committee must endorse simplification as a bedrock principle, and that principle must be communicated to all involved in the tax-writing process. Time must be taken, and effort must be made, to ensure that this goal remains paramount.

To that end, the Congress adopted as part of the IRS restructuring bill a procedure to analyze the complexity of proposals with widespread applicability to individuals or small business. By means of this complexity analysis, the Joint Committee on Taxation will call attention to provisions that could result in substantial increases in complexity, and will suggest ways in which the goals of those proposals can be achieved in simpler ways. We strongly support this increased focus on complexity and urge the members of this Committee to pay heed to the JCT analyses. Only by raising awareness of problems with proposals before they become law will Congress make substantial inroads into the problem.

We would now like to address certain specific areas in which the Tax Section considers the need for simplification immediate.

A. *Alternative Minimum Tax*

As this Committee is well aware, there is an inherent problem with the individual alternative minimum tax which, if not fixed, will result in approximately 9 million additional taxpayers becoming AMT taxpayers within the next decade. Many have referred to this problem as a ticking time bomb. Arguably, most of these taxpayers are not of the type envisioned as being subject to the AMT when it was revised in 1986. Moreover, many of these individuals will not even be aware they are subject to the AMT until completing their returns or, worse, receiving deficiency notices from the IRS.

The problem stems generally from the effects of inflation. Married couples with alternative minimum taxable income under $45,000 ($22,500 for individuals) are generally exempt from the AMT. These thresholds were effective for tax years beginning after December 31, 1992, but were not indexed for inflation. As time passes, inflation (even minimal inflation, as compounded) will erode these thresholds in terms of real dollars. As a result, more and more taxpayers will be pulled into the AMT. The problem is exacerbated by the fact that the AMT does not permit individuals to claim state taxes as a deduction against the AMT. As the income levels of these individuals increase (with inflation or otherwise), and their state tax liabilities rise correspondingly, they face the increased chance that they will be pulled into the AMT merely because they claimed state taxes as an itemized deduction for regular tax purposes.

This looming problem was compounded by the enactment of various new credits, as incentives, in the 1997 tax act. The provisions, such as the child tax credit under IRC § 24 and the Hope Scholarship and Lifetime Learning credits under IRC § 25A, do not apply for purposes of the AMT. Congress has recognized this problem by enacting a one-year moratorium (for 1998) that allows application of these incentive credits for both the regular tax and the AMT.

We urge this Committee in the strongest possible terms to solve the problems with the AMT once and for all. There is universal acknowledgement that the effects I have described are unintended and unjustified. It is also acknowledged that the revenue cost associated with a permanent solution will only increase over time and may eventually become prohibitive. It would be a travesty if a permanent solution to the AMT became caught on the merry-go-round of expiring provisions. A permanent solution should not be deferred merely because it competes with other, more popular proposals for tax reduction.

B. *Phaseout of Itemized Deductions and Personal Exemptions*

At the urging of the Tax Section, the American Bar Association at its February Mid-Year meeting adopted a recommendation that the Congress repeal the phaseout for itemized deductions (the so-called Pease provision) and the phaseout for personal exemptions (the PEP provision). We recommend that the revenue that would be lost by repeal be made up with explicit rate increases. This would address any revenue neutrality concern as well as any concern with respect to the distributional effects of repeal.

It may be difficult for members of Congress to appreciate the level of cynicism engendered by these two phaseouts. Countless times, taxpayers who might not otherwise be troubled by the amount of tax they are paying have reacted in anger when confronted with the fact that they have lost—either wholly or partially—their itemized deductions and personal exemptions. They are no more comforted when told that these phaseouts should really be viewed as substituting for an explicit rate increase. Almost without exception, they react by asking why Congress refuses to impose the additional rate rather than trying to pull the wool over their eyes.

We have no answer to that question. We take pride in the fact that a private sector organization such as the ABA is willing to recommend a simplification proposal funded by a marginal rate increase on the same taxpayers benefiting from the simplification. We urge this Committee to give serious consideration to the ABA's recommendation.

C. *Streamlining of Penalty and Interest Provisions*

The 1998 IRS Restructuring Act instructs both the Joint Committee on Taxation and the Treasury Department to conduct separate studies of the penalty and interest provisions of the Code and to make recommendations for their reform.

The Tax Section believes that reform of the penalty and interest provisions is appropriate at this time and look forward to working with the JCT and Treasury. There are many cases in which the application of penalty and interest provisions take on greater significance to taxpayers than the original tax liability itself. The Tax Section is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results. In light of the significant changes being made by the IRS, the completion of this study and eventual enactment of the recommendations will be welcome.

The Tax Section has submitted preliminary comments to the staff of the Joint Committee on Taxation that we hope will be useful in developing alternatives. We expect to submit final comments and recommendations to both the Joint Committee and Treasury in the late spring.

D. *International Simplification*

We are also pleased that various members of the Ways and Means Committee and of the Senate Finance Committee are discussing significant simplifying changes in the international tax area. In particular, we commend Messrs. Houghton and Levin of this Committee for their leadership on this issue.

Provisions of the tax code relating to international taxation are among the most complex in existence. While we recognize that taxation of individuals and corporations earning income in multiple countries necessarily involves numerous complications, we firmly believe that significant simplifying changes can be made to existing provisions without losing sight of the various principles guiding those provisions. We urge this Committee to devote significant effort to these simplification proposals, and we look forward to working with you on that effort.

PROVISIONS RELATING TO CORPORATE TAX SHELTERS

The Administration's budget includes no fewer than 16 provisions dealing in one way or another with the issue of aggressive corporate tax shelters. The purpose of our statement today is not to comment on the specifics of the Administration's proposals. We understand that the Treasury shortly will issue an amplification of its proposals. We are fully prepared to provide detailed comments on the proposals following issuance of the amplification. In the meantime, we wish to offer our own comments on the corporate tax shelter problem and suggest a course of action.

The sheer number of proposals included in the Budget obviously reflects the Treasury Department's concern about the corporate tax shelter phenomenon. While we believe the Committee should carefully consider the number of proposals included in the Budget, their possible overlap, and their potential impact on normal business transactions, the Tax Section strongly shares the Treasury's concerns with very aggressive positions being taken by taxpayers and their advisors in connection with certain transactions and the fact that these transactions frequently are being mass marketed. We also share the concern expressed by Chairman Archer regarding practices that abuse the tax code by making unintended end runs around it, and we compliment the Chairman for articulating his concern publicly and, thus, bringing additional attention to this problem.

A. *The Problem*

We have witnessed with growing alarm the aggressive use by large corporate taxpayers* of tax "products" that have little or no purpose other than reduction of Federal income taxes. We are particularly concerned about this phenomenon because it appears that the lynchpin of these transactions is the opinion of the professional tax advisor. The opinion provides a level of assurance to the purchaser of the tax plan that it will have a good chance of achieving its intended purpose. Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability. While some might dispute this as a legal conclusion, recent cases tend to support the absence of risk for penalties where favorable tax opinions have been given.

Because of our concern that opinions of tax professionals are playing such a key role in the increased use of corporate tax shelters, the Tax Section has established a task force to consider amendments to the American Bar Association's rules for standards of practice of our members. We undertook a similar project in the early 1980's when so-called "retail" tax shelters proliferated. That effort resulted in the promulgation of ABA Formal Ethics Opinion 346 and in the adoption of a similar standard in Treasury's Circular 230, which contains the ethical standards that tax professionals must comply with under threat of losing the right to practice before Treasury and IRS. We expect that our task force will recommend changes in these disciplinary rules to address the current tax shelter phenomenon.

Likewise, we are concerned about the blatant, yet secretive, marketing of these corporate tax shelters. As discussed below, unless penalties that cannot be seen as mere minor costs of doing business by the promoters are imposed upon the promoters, and strongly and diligently enforced, no end is or will be in sight.

The tax shelter products that concern us generally have the following features. First, there is a discrepancy between the book treatment of the transaction and its treatment for Federal income tax purposes (stated simply, the creation of a significant tax loss with no similar loss for financial accounting purposes). Second, there is little economic risk to the corporation from entering into the transaction other than transaction costs. Third, one party to the transaction is frequently what the Treasury refers to as "tax indifferent" (that is, a foreign taxpayer not subject to U.S.

tax, a U.S. organization exempt from Federal income tax, or a taxable U.S. corporation that has large net operating loss carryovers). Finally, and most telling, it is generally assumed by the promoter, by counsel and apparently by the taxpayer itself that, if the "product" comes to the attention of Treasury or Congressional staffs, it will be blocked, but almost invariably prospectively, by administrative action or by legislation.

The aggressive tax shelters that concern us do not overuse tax benefits consciously granted by Congress (such as accelerated depreciation or credits) nor are they tax-favored methods of accomplishing a business acquisition or financing. They are transactions that the parties themselves would generally concede have little support in sound tax or economic policy, but are, the parties assert, transactions not clearly prohibited by existing law. Not surprisingly, explicit or implicit confidentiality is also a common requisite of today's tax shelter products.

The modern tax shelter transaction usually feeds off a glitch or mistake in the tax law, often one that is accessed by finding, or even creating, a purported business purpose for entering into the transaction. Tax shelter products that capitalize on mistakes in the Code are not as troublesome to us as those that depend upon the existence of questionable facts to support the success of the product. Mistakes in the Code will eventually be discovered and corrected by the IRS, Treasury or the tax-writing Committees of Congress. When mistakes are discovered and corrected by legislation, it is the prerogative of Congress to determine whether the situation warrants retroactive application of the correction.

Far more troublesome is the practice of reducing taxes by misusing sound provisions of the Code. Exploitation of rules that generally work correctly by applying them in contexts for which they were never intended, supported by questionable factual conclusions, is the hallmark of the most aggressive tax shelters today. Discovery on audit is the tax system's principal defense, but, in a self-assessment system, the audit tool cannot be expected to uncover every sophisticated tax avoidance device. The law should provide clear incentives for taxpayers to comply with the rules and, in all events, properly to disclose the substance of complex transactions.

Thus, our concern is centered on the transaction that depends upon a dubious factual setting for success. Foremost among these is the conclusion or assertion that there is a real, non-tax business purpose or motive for entering into the transaction. There are others. In some cases, it will be essential for the opinion-giver to conclude that the transaction in question is not a step in a series of transactions, which, if collapsed into a single transaction, would not achieve the tax benefits sought. A third type of factual underpinning often essential to the delivery of a favorable tax opinion is the permanence, or intended long-term economic viability, of a business arrangement among the parties (for example, a joint venture, partnership or newly formed corporation). A venture may be represented to be a long-term business undertaking among the parties, when in fact it is a complex, single-purpose, tax-motivated arrangement which was formed shortly before and will be dissolved shortly after the tax benefit is realized.

In most of these cases, the tax law is quite clear. Without the presence of a sufficient business purpose, unless the transaction is not a step in a series of related events, or unless the new business venture represents a valid business arrangement with a sufficient degree of longevity, the tax benefit claimed is simply not available under existing law. That bears repeating. Most if not all of the tax shelter transactions that concern us depend upon avoidance of well-established principles of law such as the business purpose doctrine, the step-transaction rule, the substance-over-form doctrine, or the clear reflection of income standard. Thus, the role of the opinion giver often disintegrates into the job of designing or blessing a factual setting to support applicability of the Code provisions that will arguably produce the desired benefit. The result is the application of a provision of the Internal Revenue Code that otherwise has a logical and sound policy purpose to reach a result that is nonsensical, in some cases almost ludicrous.

A sad additional fact is that all parties to these transactions know there is substantial likelihood that the device employed, including the imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited, as most large taxpayers are. The tax law is too complex and the returns of major taxpayers are too voluminous. Many tax shelter products involve numerous parties, complex financial arrangements and invoke very sophisticated provisions of the tax law. It often takes time and painstaking analysis by well-informed auditors to ascertain that what is reported as a legitimate business transaction has little, if any, purpose other than the avoidance of Federal income taxes. Accordingly, there is a very reasonable prospect that a product will win the "audit lottery." This aspect of the problem is compounded by the fact that present law gives no reward for full disclosure in the case of corporate tax shelter transactions.

Let me emphasize that the transactions that concern us—and the tax opinions that support them—are altogether different than attempts to reduce taxes on a business transaction that has a true business or economic objective independent of reduction of Federal income taxes. But drawing distinctions between tax-dominated transactions and true business transactions that may involve major tax planning is sometimes tricky, particularly in the legislative context. For that reason, we recommend that the Congressional response to the tax shelter problem be measured and appropriate. It should not overreach; it should not risk inhibiting legitimate business transactions. As we all know, taxpayers have the right to arrange their financial affairs to pay the minimum amount of tax required under the law. Our desire is that in doing so they not avoid the intent of the law by benignly neglecting judicial and administrative principles in which the tax law is quite properly grounded.

B. *Possible Solutions*

We recommend that your emphasis be on compelling the full disclosure of the nature and true economic impact of specified classes of transactions. No taxpayer, or taxpayer's advisor, has the right to ignore or obfuscate the essential facts necessary to support the legal position relied upon to produce the desired tax benefit. Thus, we recommend that provisions be added to the Code that would give the parties a clear incentive to focus on the essential facts relied upon to bring the transaction within the applicable Code provisions. If that factual underpinning, and its legal significance, is properly understood by the taxpayer and its advisors, and is properly disclosed on the tax return, then the system will work much better. The facts to which I refer include objective facts that bear on the subjective inquiry the law requires. The inquiry would not need to state a conclusion as to the taxpayer's state of mind, but the objective facts that indicate the taxpayer's actual intent or purpose should be fully understood by the parties and clearly disclosed on the tax return.

In order to focus the inquiry on the facts relied upon to support these tax sensitive transactions, there should be a realistic possibility that penalties will be levied where the non-tax economic benefits from a transaction are slight when compared to the potential tax benefits. We agree with the Treasury Department that, in these types of transactions, promoters who market the tax shelter and professionals who render opinions supporting them should face penalties as well as the taxpayer. The Treasury Department has, in addition, suggested that tax-indifferent parties should face a potential tax if the transaction is ultimately found wanting. Under proper circumstances, that seems desirable. All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law.

You may hear the argument that changes such as those we are advocating will cause uncertainty and unreliability in the tax law. As noted earlier, the Tax Section strongly supports as much simplicity and clarity as possible throughout the Code. However, total certainty is impossible where complex transactions are involved. This is particularly true when the parties seek to avoid judicial principles developed to deny tax benefits to overly tax-motivated transactions. Taxpayers and their advisors know that relative certainty can easily be achieved in legitimate business transactions by steering a safer course and staying in the middle of the road. The more clearly the transaction stays within established judicial and administrative principles, the more certainty is assured. When they venture to the outer edge, certainty cannot be assured, nor should it be; the parties who consciously risk going over the edge should clearly understand there are severe consequences for doing so.

In an important way, the protection of common law and general anti-abuse principles contributes to certainty and reliability in the tax law. Tax shelter transactions commonly depend in large part on very literal interpretations of the words of the Code or regulations. They utilize the clarity in the way the tax law is written to undermine its purpose. In so doing, these transactions discourage the writing of clear and certain tax law in favor of more vaguely stated principles that cannot be so easily skirted. One of the important results of anti-abuse principles developed by the courts is the protection of clearly-stated provisions of law on which taxpayers can rely with certainty for every day business transactions.

As you can see, we think the best and most effective route for this Committee to follow in dealing with the corporate tax shelter problem is increased, meaningful disclosure, with proper due diligence of, and accountability for, the factual conclusions relied upon by the taxpayer. This will, perforce, have to involve an expanded penalty structure as well. If this is done properly, there may be no need for some of the more complex and broader changes Treasury has proposed. Consistent with our comments on simplicity earlier in this statement, we would encourage the Committee to be mindful of the significant complexity that could be imposed on thousands of taxpayers who are not employing tax shelters if the solutions selected to address this problem are overly broad.

Finally, this Committee and the Congress need to be certain that the Internal Revenue Service's resources are adequate to deal with the tax shelter issues. In part, promoters of tax shelters are successful in marketing their products because they and large taxpayers have concluded that the IRS is less to be feared today. They are aware of the problems within the agency, the Congressional criticism it has received, and its dwindling resources. Our recommendations are directed primarily at increased reporting and disclosure for "large tax shelters." We think such changes, together with expanded penalties, will increase voluntary compliance. However, the Internal Revenue Service must have the resources to analyze the information reported and to pursue noncompliance vigorously, or the increased reporting will be a paper tiger.

C. *Specific Proposals*

We would suggest the following changes in the Internal Revenue Code to accomplish the goals outlined:

1. Additional reporting for "tax shelters"

A question should be added to the corporate income tax return requiring the taxpayer to state whether any item on the return is attributable to an entity, plan, arrangement or transaction that constitutes a "large tax shelter" (as defined below). If the answer is yes, detailed information should be required to be furnished with the return, including:

(a) A detailed description of the facts, assumptions of facts, and factual conclusions relied upon in any opinion or advice provided by an outside tax advisor with respect to the treatment of the transaction on the return;

(b) A description of the due diligence performed by outside advisors to ascertain the accuracy of such facts, assumptions and factual conclusions;

(c) A statement signed by the corporate officer with principal knowledge of the facts that such facts, assumptions or factual conclusions are true and correct as of the date the return is filed, to the best of such person's knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon in the outside advisor's advice or opinion, the statement would need to describe such variances;

(d) Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;

(e) A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement; and

(f) A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

2. Broaden the substantial understatement penalty to cover outside advisors, promoters and "tax indifferent parties"

If the substantial understatement penalty of existing law is imposed on the taxpayer, a similar penalty should be imposed on any outside advisors and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on "tax indifferent parties," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer.

3. Definition of "large tax shelter" for purposes of the substantial understatement penalty

The definition of "tax shelter" presently contained in section 6662(d)(2)(C)(iii) should be retained. The term "large tax shelter" would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a " large tax shelter" if it were implemented as a stand-alone event, the entire transaction would constitute a "large tax shelter."

4. Specific new penalties should be provided in the case of tax shelters that fail to disclose the required information (whether or not the tax shelter is ultimately sustained or rejected by the courts)

In a self-assessment system, accurate reporting and disclosure are essential. Where that does not occur, penalties are necessary. This is particularly true in the case of large and complex tax-motivated transactions. There should be a clear disincentive to playing the audit lottery in these types of transactions. This could be coupled with a reduction in the rate of any otherwise applicable penalties for those corporations that comply with the disclosure requirements set forth in 1, above. This would provide an incentive (and not just a disincentive) to make such disclosures.

5. Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters

Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

TAXATION OF INVESTMENT INCOME OF TRADE ASSOCIATIONS

One of the proposals included in the President's budget raises serious concerns for the American Bar Association. We have been asked by the ABA to convey to this Committee its grave concerns about this proposal.

The proposal would tax all net investment income of trade associations, business leagues, chambers of commerce and professional sports leagues (under IRC § 501(c)(6)) in excess of $10,000 per year. The tax would be imposed at generally applicable corporate rates. The tax would not be imposed to the extent such net income was set aside to be used for any charitable purpose described in IRC § 170(c)(4).

The principal basis for the Administration's proposal is the erroneous assumption that the endowments that have been accumulated by some trade associations represent excessive dues payments by the members of these organizations. Thus, the Administration argues, the investment income earned on these excessive dues payments should be subject to tax just as they would have been if the dues had been set at the proper level, and the "excess" invested individually by the members of the association.

The ABA has serious reservations about this analysis. Even if it is correct to assume that these endowments represent excessive dues payments received in earlier years, the investment income earned on the excess (whether earned by the trade association or by its members) has the practical effect of reducing dues that become payable in future years. Therefore, the only significant consequence of permitting these excess dues to be invested by a tax exempt entity without taxation is to defer the government's receipt of the tax on such income from the year of the initial dues payment to the year in which the excess dues are applied to carry out the trade association's exempt activities.

We understand the theoretical economic analysis that underlies this proposal. We would submit, however, that this theoretical analysis ignores the real world, practical implications of the proposal. As a large trade association, the ABA must point out that this proposal will discourage the accumulation of endowments, severely hamper multi-year planning, and limit the ability of these organizations to fund socially desirable programs.

For example, these organizations (like any other) fund large outlays over time, rather than in the year of the outlay. Dues of trade associations and other section 501(c)(6) organizations are set at levels necessary to fund such outlays by allowing them to accumulate funds for capital expenditures, etc. A tax on investment income would make planning for such large expenditures very difficult, and highly impractical. The organizations would be forced either to collect their dues on a level basis and incur the tax (thus necessitating higher, fully deductible dues to make up the difference) or to lower their dues, not accumulate any savings, and then make special assessments in the year of the large expenditure in order to fund the project (with such special assessments also being tax deductible). There is simply no good reason to put these organizations to that choice.

There is also no valid policy reason for singling out trade associations for this treatment, but excluding other mutual-benefit organizations such as labor unions, agricultural and horticultural organizations, and civic associations. All these types of organizations, although exempt from income tax under different provisions of the tax code, are essentially treated the same for tax purposes. Given this identity of treatment, it is not appropriate to single out organizations exempt from tax under section 501(c)(6) for this new investment tax.

CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.

Chairman ARCHER. Thank you, Mr. Tucker. I am constrained to inquire whether any of those promoters might be lawyers?

Mr. TUCKER. We think that there clearly may be some, but we always remember Pogo, "We have met the enemy, and sometimes it's us."

Chairman ARCHER. OK. Mr. Sinclaire. If you will identify yourself for the record, you may proceed.

STATEMENT OF WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL AND DIRECTOR OF TAX POLICY, U.S. CHAMBER OF COMMERCE

Mr. SINCLAIRE. Mr. Chairman, Members of the Committee, I am Bill Sinclaire and I am with the U.S. Chamber of Commerce. The U.S. Chamber of Commerce appreciates this opportunity to express its views on the revenue-raising provisions in the administration's fiscal year 2000 budget proposal and to make tax relief recommendations. The U.S. Chamber is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector and region. The breadth of this membership places the Chamber in a unique position to speak for the business community.

On February 1, the administration released its budget proposal for fiscal year 2000. The proposed budget would increase taxes on businesses by approximately $80 billion over 5 years, and it would keep tax receipts, as a percentage of Gross Domestic Product, at or above 20 percent. The Chamber believes the administration's budget proposal is fraught with revenue raisers that would impinge on or replace sound tax policy with a short-sighted call for additional tax revenue. The Federal budget surplus in fiscal year 2000 will be larger than at any time since 1951, and a strong economy with substantial payments from the business community have played a significant role in this budgetary success. It would make little sense to endorse $80 billion in tax increases when considering the increase is aimed at those who have greatly contributed to this foremost accomplishment.

In addition, many of the revenue raisers in the administration's budget proposal lack a sound policy foundation. The Chamber recommends that Congress reject proposals that would increase taxes on the business community and do nothing to create jobs, increase the competitiveness of American businesses, or strengthen the U.S. economy. As we prepare for the economic challenges of the next century, we must orient our current tax policies in a way that minimizes their negative impact on taxpayers, overall economic growth, and the ability of American businesses to compete globally.

Instead of asking for the adoption of proposals that would add to the Federal tax burden on the business community, the administration should be leading the way in reducing the encumbrance in a meaningful manner, especially when the Federal Government is collecting more taxes than it needs.

Accordingly, the Chamber recommends that there be tax relief of at least the following:

First, the individual and corporate alternative tax should be completely repealed.

Second, although recently reduced for individuals, the capital gains tax should be reduced even further, and relief is still needed for corporations.

Next, Federal estate and gift tax relief should be implemented by its immediate repeal or through its phase-out over several years.

Furthermore, businesses should be able to expense the cost of their equipment purchases more rapidly. In particular, the small-business equipment expensing allowance should be increased.

Moreover, the jobs of many U.S. workers are tied to the exports and foreign investments of U.S. businesses, and job growth is becoming increasingly dependent on expanded, competitive, and strong foreign trade. The Federal Tax Code restrains U.S. businesses from competing most effectively abroad, which in turn reduces economic growth in the United States. In this regard, there should be a permanent extension to the act of financing income exception to Subpart F, and a repeal of the limitation on the amount of receipts that defense product exporters may treat as exempt foreign trade income. In addition, the Chamber has supported the International Tax Simplification for American Competitiveness Act of 1998, including its substantively similar predecessors.

Also, the research and experimentation tax credit needs to be further expanded and extended permanently so business can better rely on and utilize the credit.

In addition, the existing Federal tax laws relating to S corporations need to be updated, simplified, and reformed.

Finally, self-employed individuals can currently deduct only 60 percent of their health insurance costs. The deduction should be increased to 100 percent for 1999.

In conclusion, our country's long-term economic health depends on sound economic and tax policies. The Federal tax burden on American businesses is too high, and needs to be reduced. Our Federal Tax Code wrongly favors consumption over savings and investment. As we continue to prepare for the economic challenges of the next century, we must align our tax policies in a way that encourages more savings, investment, productivity growth, and economic growth.

Mr. Chairman, Members of the Committee, this concludes my prepared remarks, and thank you for allowing the U.S. Chamber to express its views.

[The prepared statement follows:]

Statement of William T. Sinclaire, Senior Tax Counsel and Director of Tax Policy, U.S. Chamber of Commerce

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the revenue-raising provisions in the Administration's Fiscal Year 2000 budget proposal, and to make tax-relief recommendations. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

REVENUE RAISERS IN ADMINISTRATION'S BUDGET PROPOSAL

On February 1, 1999, the Administration released its budget proposal for Fiscal Year 2000. The proposed budget would increase taxes on businesses by approximately $80 billion over five years (according to the Joint Committee on Taxation). Moreover, by the Administration's own admission, it would keep tax receipts, as a percentage of gross domestic product, at or above 20 percent for the foreseeable future.

The Chamber believes the Administration's budget proposal is fraught with revenue raisers that would impinge on or replace sound tax policy with a shortsighted call for additional tax revenue. The federal budget surplus in FY 2000 will be larger than at any time since 1951, and a strong economy with substantial tax payments from the business community have played a significant role in this budgetary success. It would make little sense to endorse $80 billion in tax increases, when considering the increase is aimed directly at those who have greatly contributed to this foremost accomplishment.

In addition, many of the revenue raisers in the Administration's budget proposal lack a sound policy foundation. The Chamber recommends that Congress reject proposals that would increase taxes on the business community and do nothing to create jobs, increase the competitiveness of American businesses, or strengthen the U.S. economy. As we prepare for the economic challenges of the next century, we must orient our current tax policies in a way that minimizes their negative impact on taxpayers, overall growth, and the ability of American businesses to compete globally.

The Administration's budget contains 16 separate proposals that are explicitly directed at so-called "corporate tax shelters." These are in addition to many others that would amend specific federal tax code provisions that the Administration believes create unwarranted tax avoidance opportunities. The corporate tax shelter proposals are undefined in scope, overlap in coverage, violate principles of income measurement and would place virtually unlimited power in the hands of the Internal Revenue Service. If enacted, they would introduce unacceptable uncertainty regarding the tax consequences of even the most basic business transactions. This is not a situation with which the business community should be subjected.

Included in, and in addition to the 16 corporate tax shelter provisions, the Administration's budget proposal contains numerous provisions that would raise revenue. By way of example, and not limitation, these objectionable provisions include the following:

Replace Export Source-Rule With Activity-Based Rule—Under current law, if inventory is purchased or manufactured in the U.S. and sold abroad, 50 percent of the income is treated as earned by production activities (U.S.-source income) and 50 percent by sales activities (foreign-source income). This law is beneficial to U.S. manufacturing companies that export overseas because it increases their ability to utilize foreign tax credits and alleviate double taxation. The Administration proposes that the allocation between production and sales activities be based on actual economic activity. This proposal, however, could increase U.S. taxes on export companies and, therefore, encourage them to produce their goods overseas, rather than in the United States.

Capitalize Acquisition Costs—Insurance companies would be required to capitalize modified percentages of their net premiums for certain insurance contracts in order to more accurately reflect the ratio of actual policy acquisition expenses to net premiums and the typical useful lives of the contracts. This provision would increase the tax liabilities of insurance companies, which in turn would be passed on to its customers.

Require Monthly Deposits Of Unemployment Taxes—Beginning in 2005, employers would be required to deposit their federal and state unemployment taxes monthly, instead of quarterly, if an employer's federal unemployment tax liability in the prior year was $1,100 or more. This provision, which would not bring in any additional revenue to the government, would impose an undue administrative burden on businesses, especially smaller businesses.

Tax Net Investment Income Of Trade Associations—Trade associations, chambers of commerce, non-profit business leagues and professional sports leagues that have annual net investment income exceeding $10,000 would be subject to the unrelated business income tax on their excess net investment income. This provision, which does not apply to labor unions and other tax-exempt entities, would groundlessly tax properly invested funds that would later be used to further the tax-exempt purposes of non-profit entities.

Increase The Proration Percentage—Property and casualty insurance companies would have to increase the proration percentage on their funding of loss reserves by income that may, in whole or part, be exempt from tax. With the property and casualty industry investing 21 percent of their financial assets in, and holding about 14 percent of all tax-exempt debt, there could be a reduction in demand for tax-exempt debt and a rise in the interest rates of tax exempt obligations.

Repeal Lower-Of-Cost-Or-Market Inventory Accounting Method—Taxpayers would no longer be able to value their inventories by applying the lower-of-cost-or-market accounting method or by writing down the cost of goods that are unsalable at normal prices or unusable in their usual way because of damage, imperfection or other similar causes. This provision would increase taxes on those businesses that use the "first-in-first-out" method or cause them to switch to the "last-in-last-out" method for both tax and financial statement purposes.

Repeal The Installment Method For Accrual Basis Taxpayers—The installment method of accounting (which allows a taxpayer to defer recognition of income on the sale of certain property until payments are received) would no longer be available for accrual basis taxpayers. This provision would cause taxpayers to either pay tax on gains which have not yet been received or convert to the cash basis.

Modify The Corporate-Owned Life Insurance Rules—The Administration would repeal the exception under the corporate-owned life insurance rules proration rules for contracts insuring employees, officers or directors (other than 20 percent owners) of a business. This provision could have a devastating effect on life insurance products that protect businesses, especially small businesses, against financial loss caused by the death of their key employees.

Deny Tax Benefits Resulting From Non-Economic Transactions—Proposals would increase the substantial understatement penalty for corporate taxpayers from 20 percent to 40 percent for items attributable to a corporate tax shelter, deny certain tax benefits obtained in a corporate tax shelter, deny deductions for certain tax advice, impose an excise tax on fees received in connection to corporate tax shelters, and impose an excise tax on certain tax benefit protection arrangements. These proposals unfairly target legitimate tax saving devices and related expenses and should be dismissed.

Deny Deductions For Punitive Damages—No deduction would be allowed for punitive damages paid or incurred by a taxpayer, whether upon judgment or in settlement of a claim. In addition, where the punitive damages are paid by an insurance company, the taxpayer would be required to include in gross income the amount of damages paid on its behalf. This provision would deny businesses the ability to deduct legitimate business expenses relating to legal claims.

Repeal Tax-Free Conversions Of Large C-Corporations To S-Corporations—Under current law, the conversion of a C-corporation to an S-corporation is generally tax-free. The "built-in" gains of a corporation's assets are not taxed if the assets are not sold within 10 years of conversion. The Administration proposes to treat the conversion of a "large" C-corporation (those with a value exceeding $5 million) into an S-corporation as a taxable event to both the corporation (with respected to its appreciated assets) and its shareholders (with respect to their stock). This provision would prevent many C-corporations that want to avoid double taxation from electing to be S-corporations.

Eliminate Non-Business Valuation Discounts—Valuation discounts on the minority interests of family limited partnerships or limited liability companies would no longer be allowed for estate and gift tax purposes unless such entities are active businesses. This provision would make it more difficult for business owners to develop estate plans that would keep their businesses intact, and their employees working, after their deaths.

Require The Recapture Of Policyholder Surplus Accounts—The Administration would require stock life insurance companies with policyholder surplus accounts to include in the income the amount in the account. This proposal is contrary to the intent of Congress in enacting current law.

Modify Rules For Debt-Financed Portfolio Stock—This proposal by the Administration would effectively reduce the dividends-received deduction (the "DRD") for any corporation carrying debt (virtually all corporations) and would specifically target financial service companies, which tend to be more debt-financed. The purpose of the DRD is to eliminate, or at least alleviate, the impact of potential multiple layers of corporate taxation. However, this proposal would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more fair, rational, and simple tax system.

Deny The DRD For Certain Preferred Stock—This is another proposal that would deny the DRD for certain types of preferred stock which the Administration believes are more like debt than equity. Although concerned that dividend payment from such preferred stock more closely resemble interest payment than debt, the proposal does not include a provision to allow issuers to take interest expense deductions on such payments. Accordingly, the instruments would be denied both equity and debt tax benefits.

Reinstate Superfund Excise Taxes And The Environmental Tax On Corporate Income—Excise taxes which were levied on various petroleum products, chemicals and imported substances and dedicated to the Superfund Trust Fund would be reinstated through September 30, 2009. The corporate environmental income tax (which was also dedicated to the Superfund Trust Fund) would be reinstated through December 31, 2009. These taxes expired on December 31, 1995. These Superfund taxes should be thoroughly examined, evaluated and made part of a comprehensive plan to reform the Superfund program before they are reinstated.

Defer Interest Deduction And Original Issue Discount On Certain Convertible Debt—The Administration has proposed to defer deductions for interest accrued on convertible debt instruments with original issue discount ("OID") until the interest is paid in cash. However, these hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise billions of dollars of investment capital. This proposal is contrary to sound tax policy that matches the accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. Re-characterizing these instruments as equity for tax purposes is fundamentally incorrect and would put American companies at a distinct disadvantage to their foreign competitors, which are not bound by such restrictions.

Increase Taxes On Tobacco Sales—The Administration plans to propose tobacco legislation that would raise revenues of $34.5 billion over the next five years. Regardless of the Administration's altruistic motives to reduce teenage smoking, levying such a huge tax increase on a single industry would set a dangerous precedent for future tax increases on other industries.

Convert Airport And Airway Excise Taxes To Cost-Based User Fees—Excise taxes which are currently levied on domestic and international air passenger transportation and domestic air freight transportation and deposited in the Airport and Airway Trust Fund would be reduced as new cost-based user fees for air traffic services are phased in beginning in 2000. The excise taxes would be reduced as necessary to ensure that the amount collected each year from the user fees and excise taxes is, in the aggregate, equal to the total budget resources requested for the Federal Aviation Administration in the succeeding year. A $5.3 billion tax increase on the business community and the public-at-large, especially before the issue of whether existing excise taxes should be replaced by cost-based user fees is fully debated, is unacceptable and should be thwarted.

Business Tax Relief is Needed

Instead of asking for the adoption of proposals that would add to the federal tax burden on the business community, the Administration should be leading the way in reducing the encumbrance in a meaningful manner especially when the federal government is collecting more taxes than it needs. Accordingly, the Chamber recommends that there be tax relief in at least the following areas:

Alternative Minimum Tax—Both the individual and corporate alternative minimum tax ("AMT") negatively affect American businesses, particularly those that invest heavily in capital assets. The Taxpayer Relief Act of 1997 (the "1997 Act") exempts "small business corporations" from the corporate AMT, however, unincorporated businesses are still subject to the individual AMT, and larger corporations remain subject to the corporate AMT.

While the Chamber supports the full repeal of both the individual and corporate AMT, to the extent complete repeal is not feasible, significant reforms should be enacted. Such reforms include providing a "small business" exemption for individual taxpayers; eliminating the depreciation adjustment; increasing the individual AMT exemption amounts; allowing taxpayers to offset their current year AMT liabilities with accumulated minimum tax credits; and making the AMT system less complicated and easier to comply with.

Capital Gains Tax—Lower capital gains tax rates for both individuals and corporations would help maintain our growing economy by promoting capital investment and mobility. Although the 1997 Act reduced the maximum capital gains tax rate for individuals from 28 percent to 20 percent (10 percent for those in the 15-percent income-tax bracket), it should be reduced even further. In addition, capital gains tax relief is still needed for corporations, whose capital gains continue to be taxed at regular corporate income tax rates (to a maximum of 35 percent).

Estate and Gift Tax—The federal estate and gift tax is an inefficient, distortive tax that discourages saving, investment and job growth, unfairly penalizes small businesses, and accounts for little more than one percent of total federal revenues. It can deplete the estates of those who have saved their entire lives and force successful small businesses to liquidate or lay off workers. With a maximum rate of 55 percent, the tax is confiscatory, and its compliance, planning and collection costs are extremely high in relationship to the tax collected (according to the Joint Economic Committee).

The Chamber supports legislation introduced by Representative Cox (R–CA) and Senator Kyl (R–AZ), the Family Heritage Preservation Act (H.R. 86; S. 56), which would immediately repeal the estate and gift tax, as well as legislation introduced by Representatives Dunn (R–WA) and Tanner (D–TN) and Senator Campbell (R–CO), the Estate and Gift Tax Rate Reduction Act of 1999 (H.R. 8; S. 38), which would phase-out the tax over 11 years by annually reducing each rate of tax by five percentage points.

Equipment Expensing—In order to spur additional investment in income-producing assets, businesses should be able to fully expense the cost of their equipment purchases in the year of purchase. In particular, the small business equipment expensing allowance—which is $19,000 for 1999 and scheduled to increase to $25,000 by 2003—should be increased or immediately accelerated to the $25,000 amount.

Foreign Tax Rules—The jobs of many U.S. workers are tied to the exports and foreign investments of U.S. businesses and job growth is becoming increasingly dependent on expanded, competitive, and strong foreign trade. The current federal tax code restrains U.S. businesses from competing most effectively abroad—which in turn reduces economic growth in the U.S. While the 1997 Act contained some foreign tax relief and simplification measures, our foreign tax rules need to be further simplified and reformed so American businesses can better compete in today's global economy.

The Chamber supported the International Tax Simplification for American Competitiveness Act of 1998 (H.R. 4173; S 2231), introduced by Representatives Houghton and Levin, and Senators Hatch and Baucus in the 105th Congress, and its substantively similar predecessors in the 105th and prior Congresses. The Chamber also supports legislation (H.R. 681), introduced by Representatives McCrery (R–LA) and Neal (D–MA), which would permanently extend the active financing income exception to Subpart F, and the Defense Jobs and Trade Promotion Act of 1999 (H.R. 796), introduced by Representative S. Johnson (R–TX), which would repeal the limitation on the amount of receipts that defense product exporters may treat as exempt foreign trade income.

Independent Contractor/Worker Classification—The reclassification by the Internal Revenue Service of workers from independent contractors to employees can be devastating to business owners, as it can subject them to large amounts of back federal and state taxes, penalties and interest. Existing classification rules must be simplified and clarified so disputes with the IRS are minimized. The Chamber has supported legislation that would provide more objective "safe harbors" for determining the status of a worker.

Research and Experimentation Tax Credit—The research and experimentation ("R&E") tax credit encourages companies to invest additional resources into the research, development and experimentation of products and services that benefit society as a whole. While the 1998 Omnibus Budget Bill extended this credit through June 30, 1999, it needs to be extended permanently, and further expanded, so businesses can better rely on and utilize the credit. The Chamber supports legislation (H.R. 835) introduced by Representatives Johnson (R–CT) and Matsui (D–CA) which expands and permanently extends the R&E tax credit.

S-Corporation Reform—The existing federal tax laws relating to S-corporations need to be updated, simplified and reformed so small businesses can access more funds and better compete in today's economy. While various relief provisions were enacted in 1996, other reforms still need to be implemented, including the allowance of "plain vanilla" stock, elimination of "excess passive investment income" as a termination event, and modification of how certain fringe benefits are taxed to S corporation shareholders. The Chamber supports legislation introduced by Representative Shaw (R–FL), the Subchapter S Revision Act of 1999 (H.R. 689), which contains these and other measures.

Self-Employed Health Insurance Deduction—Self-employed individuals can only deduct a portion of their health insurance costs each year (60 percent in 1999, 2000, 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter). The Chamber believes that the self-employed should be able to fully deduct their health insurance expenses in the year incurred.

CONCLUSION

Our country's long-term economic health depends on sound economic and tax policies. The federal tax burden on American businesses is too high and needs to be reduced. Our federal tax code wrongly favors consumption over savings and investment. As we continue to prepare for the economic challenges of the next century, we must orient our tax policies in a way that encourages more savings, investment, productivity growth, and economic growth.

The revenue-raising provisions contained in the Administration's Fiscal Year 2000 budget proposal would further increase taxes on businesses and reduce savings and investment. The U.S. Chamber urges that these provisions be rejected, and not included in any legislation.

Chairman ARCHER. Thank you, Mr. Sinclaire.

Mr. Lifson, if you will identify yourself for the record, you may proceed.

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LIFSON. My name is David Lifson. Thank you, Mr. Chairman. I am the chair of the Tax Executive Committee of the American Institute of CPAs. We are pleased to present our comments on selected revenue proposals in the President's fiscal year 2000 budget.

Our members work daily with the tax provisions that you enact, and we are committed to helping make our tax system as simple and as fair as possible. The tax law is exceedingly difficult, and we help our clients cope with its complexity.

Our involvement with taxpayers assists both the government and our clients by assuring that taxpayers pay their fair share of taxes but no more. Where the tax law is complex, we want to work with you to craft legislation that accomplishes your policy objectives with the least possible confusion and uncertainty for taxpayers.

We have several major concerns about the administration's proposal. In recent years, tax legislation has increasingly included complex thresholds, ceiling, phase-ins, phase-outs, effective dates, and sunset dates in your efforts to provide benefits within the limits of revenue neutrality. The administration's budget tax proposals would increase complexity through the numerous proposed targeted credits.

While we have no doubt that these credits are well-intentioned, cumulatively, they would further weigh down our tax system. Many average taxpayers do not understand the benefit to which they are entitled, and while it is still early, we believe that many taxpayers will miss some of the benefits that you intended to deliver to them on their 1998 tax return.

Other taxpayers are disappointed to learn that they do not qualify for benefits that they have heard about because complex fine-print phase-outs disqualify them. Taxpayers cannot be expected to plan, and they have trouble even complying with this level of complexity.

We have provided you with a detailed recommendation for standard phase-ins and phase-outs. It would greatly simplify the tax law, particularly as it applies to middle-income families. This involves simplifying over 65 different provisions in the Tax Code in three concise areas.

Another area that needs no complexity introduction, is the alternative minimum tax. We are concerned that while it is a good idea to enact the proposed credit, the proposed additional adjustment in the budget for the next 2 years, to keep the alternative minimum tax from encroaching on people for whom it was not intended.

We ultimately encourage you to repeal the AMT. If you cannot find a way to repeal it, you need to greatly simplify it. I won't repeat the many wise comments that were made earlier that many of the elements that were left over in the AMT no longer serve their purpose.

Another area that we are extremely concerned about is section 127, Education Exclusion. We think there needs to be certainty in education benefits, and we don't understand why that shouldn't be made a permanent change so students could plan 4-year careers with reasonable certainty about the tax law.

We also applaud—we have some things we can applaud about the administration's proposals, especially the portability of retirement savings and pension plans. This is an area where we think it is important that citizens be given more responsibility for their own retirement savings, and is very consistent with the realities on the concerns of today's very mobile work force.

The administration has proposed measures to curtail what are described as tax avoidance transactions. We oppose abuses of our tax system by improper activities, and believe that their restriction makes the tax system fairer for all. However, Congress should carefully examine the Treasury's proposals. Since we believe that part of abuse curtailment, the administration is recommending policies that are not properly focused and would not address the issues.

Further, we know that you have instructed the IRS and Treasury and Joint Tax Committee to come up with a rationalization of the penalty and interest system. We think that is the place for penalty reform to be debated. We think that if penalties are not clearly understood by the participants, then they will not act as a deterrent for behavior that is objectionable to this Congress.

We also oppose the administration's proposed tax on investment income of trade associations. The recommendation is not consistent with the general thrust of the tax law, and it would bring additional taxes and further layers of complexity to many small and medium-size business organizations.

We thank you for the time to comment on some specific proposals. We have a lengthy submission with some solutions as well as raising problems.

Thank you for your time, and we stand at the ready.

[The prepared statement follows:]

Statement of David A. Lifson, Chair, Tax Executive Committee, American Institute of Certified Public Accountants

Mr. Chairman, and members of this distinguished committee:

My name is David A. Lifson, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to present to you, today, our comments on selected revenue proposals in the President's fiscal year 2000 budget. The AICPA is the professional association of certified public accountants, with more than 330,000 members, many of whom provide comprehensive tax services to all types of taxpayers, including businesses and individuals, in various financial situations. Our members work daily with the tax provisions you enact, and we are committed to helping make our tax system as simple and fair as possible.

The tax law is exceedingly difficult, and we help our clients cope with this complexity. Our involvement with taxpayers assists both client and government by assuring that taxpayers pay their fair share of taxes and no more. Where the tax law is complex, we want to work with you to craft legislation that accomplishes your objectives with the least possible confusion and uncertainty for taxpayers.

We have several major concerns about the Administration's proposals. In recent years, tax legislation has increasingly included complex thresholds, ceilings, phase-ins, phase-outs, effective dates, and sunset dates in an effort to provide benefits as broadly as possible within the limits of revenue neutrality. The Administration's budget tax proposals, as drafted, continue this trend through the numerous proposed targeted credits. While these credits are well-intentioned, cumulatively they would further weigh down our tax system with complexity. Many average taxpayers do not understand the benefits to which they are entitled, and while it is still early, we believe that taxpayers will miss some of the benefits that you intended for them to take on their 1998 returns all too frequently. Other taxpayers are disappointed to learn that they do not qualify for benefits that they have heard about because of complex, fine-print phase-outs. Taxpayers cannot plan and they have trouble even complying with this complexity. Our statement below contains a recommendation for standard phase-ins and phase-outs that will greatly simplify the tax law, particularly as it applies to middle income families. Depending on the income levels of phase-ins and phase-outs, this proposal should not be unduly expensive, and would be a substantial improvement to our tax system. In the area of tax simplification, we also encourage you to consider alternatives to targeted tax credits and cuts, including an increased standard deduction, increased personal exemption amount, reduction of the income level at which current rates apply, and relief from the marriage penalty.

The Administration's proposal extends, for two years, refundable credits against the individual alternative minimum tax to offset the application of AMT to middle-income taxpayers as a result of credits enacted in the Taxpayer Relief Act of 1997. At that time, we brought these problems to your attention, and while we support the temporary relief the Administration proposes, we strongly encourage you to repeal the AMT or at least greatly simplify it. The AMT is a burden on our tax system, and this burden is increasingly being placed on middle-income taxpayers. We have included detailed recommendations for AMT simplification in our statement in the event you reject the cause for outright repeal.

The Section 127 exclusion for employer-provided educational assistance needs to have greater stability in our tax law. While the temporary extension proposed in the budget is helpful, it does not provide the dependably consistent incentive that will encourage students to undertake the substantial personal and financial commitment necessary to prepare them for the future. Section 127 education benefits should be made permanent, not just extended.

We applaud the Administration's proposals to improve the portability of retirement savings and pension plans. This helps citizens take greater responsibility for their retirement savings and is consistent with today's mobile workforce.

The Administration has proposed measures to curtail what are described as "tax avoidance transactions." We oppose abuses of our tax system by improper activities, and believe that their restriction makes the tax system fairer for all. However, Congress should carefully examine Treasury's proposals, since we believe, as part of abuse curtailment, the Administration is recommending standards that are not properly focussed or defined to address the issues. Many have already observed that the proposed standards are overly broad and vague. Further, new or enhanced penalties to encourage compliance in this area should be considered as part of the penalty study presently being undertaken by the Joint Tax Committee staff and the Treasury Department, not just as add-ons to an already patchwork tax penalty structure. We would be happy to work with Congress and the Treasury in distinguishing between legitimate tax planning and improper tax activities.

We oppose the Administration's proposal to tax investment income of trade associations. This recommendation is not consistent with the general thrust of the tax law in making these organizations exempt and is not consistent with sound business practices of trade associations. The proposal would bring additional taxes and complexity to many small and medium-sized organizations.

The AICPA has not fully completed its review of the Administration's budget tax proposals. We have commented on some specific proposals below and hope to provide additional comments as soon as our committees complete their work. We appreciate this opportunity to provide comments and would be happy to answer any questions. Please contact David Lifson, Chair of the Tax Executive Committee, or Gerald

Padwe, Vice-President-Taxation of the AICPA, if we can be of assistance. Thank you for considering our comments.

I. INDIVIDUAL INCOME TAX PROPOSALS GENERALLY

The Administration's revenue proposals contain numerous provisions affecting individuals, such as: a new long-term care credit, a new disabled workers tax credit, the child and dependent care tax credit expansion, the employer-provided educational assistance exclusion extension, a new energy efficient new homes credit, the electric vehicles credit extension, AMT relief extension, a new D.C. homebuyers credit, optional self-employment contributions computations, a new severance pay exemption, a new rental income inclusion, etc. While we are not commenting on the policy need for these provisions, we note that Congress must consider the general administrability of these provisions.

We are very concerned about the increasing complexity of the tax law as a result of targeted individual tax cuts. The 1997 Taxpayer Relief Act contained several targeted individual tax cuts that were first effective for 1998 individual income tax returns. As discussed in the Wall Street Journal of February 17, 1999, these provisions, while providing tax relief to certain individuals, have greatly increased the complexity of the preparation of individual income tax returns. This increased compliance burden is born mostly by lower income taxpayers who can least afford the cost of hiring a professional income tax return preparer.

IRS National Taxpayer Advocate W. Val Oveson, in his first report to Congress, stated that increasing tax law complexity is imposing significant compliance and administrative burdens on the IRS and taxpayers. The report also cited the increasing complexity caused by the targeted individual tax cuts contained in the 1997 Taxpayer Relief Act.

The Administration's tax proposals contain 28 new targeted tax cuts. Many of these provisions have limited applicability; none are available to high-income taxpayers. Unfortunately, the way these provisions are drafted with different income limits for each provision, taxpayers need to make many additional tax calculations just to determine if they are eligible for the tax benefit. The Administration's tax proposals will add several additional income limits to the Internal Revenue Code.

Below are a few examples of provisions in the Administration's tax proposals that have different phase-out limits:

- The long-term care credit and disabled workers tax credit would be phased out "by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds" $110,000 (married filing a joint return taxpayers), $75,000 (single/head of household), or $55,000 married filing separate.
- The first-time D.C. homebuyers credit phases out for individuals with AGI between $70,000 and $90,000 ($110,000 to $130,000 for joint filers).
- The severance pay exemption would not apply if the total severance payments received exceed $75,000.
- The expanded child and dependent care credit proposal would allow taxpayers the 50 percent credit rate if their AGI is $300,000 or less, then the credit rate would be reduced by one percentage point for each additional $1,000 of AGI in excess of $300,000, and taxpayers with AGI over $59,000 would be eligible for a 20 percent credit rate.
- The student loan interest deduction (to which the President's proposal would eliminate the current 60-month limit) phases out ratably for single taxpayers with AGI between $40,000 and $55,000 and between $60,000 and $75,000 for married filing a joint return taxpayers.

This type of law, with so many different phase-out limits, provides incredible challenges for middle-income taxpayers, in determining how much of what benefit they are entitled to. We suggest common phase-out limits among all individual tax provisions in order to target benefits to one of three uniform groups and simplify the law. Our phase-out simplification proposal is attached.

Another problem with these targeted tax cuts is that the impact of the alternative minimum tax (AMT) on these cuts is not adequately addressed. This is evidenced by the provision in the 1998 IRS Restructuring and Return Act and the provision in the Administration's tax proposals that provide temporary relief from the AMT for individuals qualifying for some of the targeted tax credits. We believe that the individual alternative minimum tax needs to be simplified; our proposal is attached.

Finally, much of the complexity in the individual income tax system is the result of recent efforts to provide meaningful tax relief to medium and low-income taxpayers. In order to aid simplification, we believe that Congress should consider alternatives to targeted tax cuts, including the new ones proposed by the Administration, with provisions such as the following:

• Increased standard deduction.
• Increased amount for personal exemptions.
• Increasing the taxable income level where the 28 percent tax and the 31 percent tax rate begins.
• Marriage penalty relief.

The AICPA would like to further study the complexity caused by the proliferation of credits with their complex provisions, and hopes to provide further specific comments as this legislation progresses.

Phase-Outs Based on Income Level

Present Law.—Numerous sections in the tax law provide for the phase-out of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is currently no consistency among these phase-outs in either the measure of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Furthermore, the ranges for a particular phase-out often differ depending on filing status, but even these differences are not consistent. For example, the traditional IRA deduction phases out over a different range of income for single filers than it does for married-joint filers; whereas the $25,000 allowance for passive losses from rental activities for active participants phases out over the same range of income for both single and married-joint filers. Consequently, these phase-outs cause inordinate complexity, particularly for taxpayers attempting to prepare their tax returns by hand; and the instructions for applying the phase-outs are of relatively little help. See the attached Exhibit for a listing of most current phase-outs, including their respective income measurements, phase-out ranges (for 1998) and phase-out methods.

Note that currently many the phase-out ranges for married-filing-separate (MFS) taxpayers are 50 percent of the range for married-filing-joint (MFJ), while many of the phase-out ranges for single and head of household (HOH) taxpayers are 75 percent of married-joint. That causes a marriage penalty when the spouses' incomes are relatively equal.

Recommended Change.—True simplification could easily be accomplished by eliminating phase-outs altogether. However, if that is considered either unfair (simplicity is often at odds with equity) or bad tax policy, significant simplification can be achieved by creating consistency in the measure of income, the range of phase-out (including as between filing statuses) and the method of phase-out.

Instead of the approximately 20 different phase-out ranges (shown in attached Exhibit A), there should only be three—at levels representing low, middle, and high income taxpayers.

If there are revenue concerns, the ranges and percentages could be adjusted, as long as the phase-outs for each income level group (i.e., low, middle, high income) stayed consistent across all relevant provisions. In addition, marriage penalty impact should be considered in adjusting phase-out ranges for revenue needs.

We propose that, in an effort to eliminate the marriage penalty and simplify the Code, all phase-out ranges for married-filing-separate (MFS) taxpayers should be the same as those for single and head of household (HOH) taxpayers, which would be 50 percent of the range for married-filing-joint (MFJ) range.

The benefits that are specifically targeted to low-income taxpayers, such as the earned income credit, elderly credit, and dependent care credit, would phase-out under the low-income taxpayer phase-out range. The benefits that are targeted to low and middle income taxpayers, such as the traditional IRA deduction and education loan interest expense deduction, would phase-out under the middle-income taxpayer phase-out range. Likewise, those benefits that are targeted not to exceed high income levels, such as the new child credit, the new education credits and Education IRA, and the new Roth IRA, as well as the existing law AMT exemption, itemized deductions, personal exemptions, adoption credit and exclusion, series EE bond exclusion, and section 469 $25,000 rental exclusion and credit, would phase-out under the high-income taxpayer phase-out range. See the chart below.

Proposed Adjusted Gross Income Level Range for Beginning to End of Phase-Out for Each Filing Status

Category of Taxpayer	Married Filing Joint	Single & HOH & MFS
LOW-INCOME	$ 15,000–$ 37,500	$ 7,500–$ 18,750
MIDDLE-INCOME	$ 60,000–$ 75,000	$ 30,000–$ 37,500
HIGH-INCOME	$225,000–$450,000	$ 112,500–$225,000

EXHIBIT A—Selected AGI Phase-Out Amounts

IRC Section	Provision	Ft nt.	Current-Joint	Current—Single & HOH	Current—Married/Sep.	Proposed-Joint	Proposed—Single & HOH & MFS
PHASE-OUT LEVELS FOR LOW-INCOME TAXPAYERS							
21	30 Percent Dependent Care Credit.	(3)	$10,000–$20,000	$10,000–$20,000	No credit	$15,000–$37,500	$7,500–$18,750
22	Elderly Credit	(4)	$10,000–$25,000	$7,500–$17,500	$5,000–$12,500	$15,000–$37,500	$7,500–$18,750
32	EITC (No Child)	(2,3,4)	$5,570–$10,030	$10,030	No credit	$15,000–$37,500	$7,500–$18,750
32	EITC (1 Child)	(2,3,4)	$12,260–$26,473	$12,260–$26,473	No credit	$15,000–$37,500	$7,500–$18,750
32	EITC (2 or More Children).	(2,3,4)	$12,260–$30,095	$12,260–$30,095	No credit	$15,000–$37,500	$7,500–$18,750
PHASE-OUT LEVELS FOR MIDDLE-INCOME TAXPAYERS							
219	IRA Deduction w/ retirement plan.	(1,7,9)	$50,000–$60,000	$30,000–$40,000	No deduction	$60,000–$75,000	$30,000–$37,500
221	Education Loan Interest Exp..	(1,2,6)	$60,000–$75,000	$40,000–$55,000	No deduction	$60,000–$75,000	$30,000–$37,500
PHASE-OUT LEVELS FOR HIGH-INCOME TAXPAYERS							
24	Child Credit	(1,5,6)	$110,000–	$75,000–	$55,000–	$225,000–$450,000	$112,500–$225,000
25A	Hope Credit & Lifetm. Lrng. Cr..	(1,2,6)	$80,000–$100,000	$40,000–$50,000	No credit	$225,000–$450,000	$112,500–$225,000
23 & 137	Adoption Credit/ Exclusion.	(1,7)	$75,000–$115,000	$75,000–$115,000	No benefit	$225,000–$450,000	$112,500–$225,000
55(d)	AMT Exemption	(1,8)	$150,000–$330,000	$112,500–$247,500	$75,000–$165,000	$225,000–$450,000	$112,500–$225,000
68	Itemized Deduction level.	(2)	$124,500–	$124,500–	$62,250–	$225,000–$450,000	$112,500–$225,000
135	EE Bond int. Exclusion.	(1,2,7)	$78,350–$108,350	$52,250–$67,250	No exclusion	$225,000–$450,000	$112,500–$225,000
151	Personal Exemption.	(2)	$186,800–$309,300	$124,500–$247,000 HOH$155,650–$278,150	$93,400–$154,650	$225,000–$450,000	$112,500–$225,000
219(g)(7)	IRAw/spouse w/ retrmt.plan.	(1,6,7)	$150,000–$160,000	Not applicable	No deduction	$225,000–$450,000	$112,500–$225,000

408A	Roth IRA Deduction.	(1,6)	$150,000–$160,000	$95,000–$110,000	No deduction	$225,000–$450,000	$112,500–$225,000
408A	IRA to Roth IRA Rollover.	(1,6,7)	$100,000	$100,000	No rollover	$225,000–$450,000	$112,500–$225,000
469(i)	$25,000 Rent Passive Loss.	(1,7)	$100,000–$150,000	$100,000–$150,000	$50,000–$75,000 ...	$225,000–$450,000	$112,500–$225,000
469(i)	Passive Rehab. Credit.	(1,7)	$200,000–$250,000	$200,000–$250,000	$100,000–$125,000	$225,000–$450,000	$112,500–$225,000
530	Education IRA Deduction.	(1,6)	$150,000–$160,000	$95,000–$110,000	No deduction	$225,000–$450,000	$112,500–$225,000

Footnotes: (1) Modifications to AGI apply; (2) Inflation indexed; (3) Earned income limitations; (4) Low income only; (5) Phase-out range depends on number of children; (6) Newly enacted in 1997; (7) Also see section 221(b)(2); (8) Phase-out applies to alternative minimum taxable income rather than AGI; (9) Increases for future years are specifically provided in the statute.

Additionally, instead of the differing methods of phase-outs (shown in attached Exhibit B), the phase-out methodology for all phase-outs would be the same, such that the benefit phases out evenly over the phase-out range. Every phase-out should be based on adjusted gross income (AGI).

EXHIBIT B—Current Method of Phase-Out

Code Section(s)	Tax Provision	Current Methodology for Phase-outs Application
21	Dependent Care Credit	Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income
22	Elderly Credit	Credit amount reduced by excess over AGI range
23 & 137	Adoption Credit & Exclusion.	Benefit reduced by excess of modified AGI over lowest amount noted divided by 40,000
24	Child Credit	Credit reduced by $50 for each $1,000 in modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
25A	Education Credits (Hope/Lifetime Learning).	Credits reduced by excess of modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
32	Earned Income Credit	Credit determined by earned income and AGI levels
55	AMT Exemption	Exemption reduced by ¼ of AGI in excess of lowest amount noted
68	Itemized Deductions	Itemized deductions reduced by 3 percent of excess AGI over amount noted
135	Series EE Bonds	Excess of modified AGI over lowest amount divided by 15,000 (single), 30,000 (joint) reduces excludable amount
151	Personal Exemption	AGI in excess of lowest amount, divided by 2,500, rounded to nearest whole number, multiplied by 2, equals the percentage reduction in the exemption amounts
219	Traditional IRA w/ Retirement Plan.	Individual retirement account (IRA) limitation ($2,000/$4,000) reduced by excess of AGI over lowest amount noted divided by $10,000
219(g)(7)	IRA w/Spouse w/ Retiremt. Plan.	Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by 10,000
221	Education Loan Interest Expense Deduction.	Deduction reduced by excess of modified AGI over lowest amount noted divided by 15,000
408A	Roth IRA	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)
408A	IRA Rollover-Roth IRA	Rollover not permitted if AGI exceeds 100,000 or if MFS
469(i)	Passive Loss Rental $25,000 Rule.	Benefit reduced by 50 percent of AGI over lowest amount noted
530	Education IRA Deduction	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)

Contribution to Simplification.—The current law phase-outs complicate tax returns immensely and impose marriage penalties. The instructions related to these phase-outs are difficult to understand and the computations often cannot be done by the average taxpayer by hand. The differences among the various phase-out income levels are tremendous. Either we should eliminate phase-outs and accomplish the same goal with a lot less complexity by adjusting rates, or at least make the phase-outs applicable at consistent income levels (only three) and apply them to consistent ranges and use a consistent methodology. This would ease the compliance burden on many individuals. If there were only three ranges to know and only one methodology, it would be easier to recognize when and how a phase-out applies. Portions of numerous Internal Revenue Code sections could be eliminated. By making the MFJ phase-out ranges double the ranges applicable to single individuals, and by making the MFS ranges the same as single individuals, the marriage penalty associated with phase-out ranges would be eliminated.

Alternative Minimum Tax Proposal

Background on AMT.—The budget proposals would extend, for two years, the availability of refundable credits against the individual alternative minimum tax. Thus, this issue has now joined the list of "extenders" or "expiring provisions" which Congress must address every few years, searching for the revenues to prevent some tax inequity (as here) or maintain some tax incentive.

We are clearly pleased to support this proposal, but we would caution the Congress (as we have in the past) that there are many more issues with the individual AMT that need to be addressed. Some of these issues are discussed below.

Complexity of AMT.—The AMT is one of the most complex parts of the tax system. Each of the adjustments of Internal Revenue Code (IRC) section 56, and preferences of IRC section 57, requires computation of the income or expense item under the separate AMT system. The supplementary schedules used to compute many of the necessary adjustments and preferences must be maintained for many years to allow the computation of future AMT as items turn around.

Generally, the fact that AMT cannot always be calculated directly from information on the tax return makes the computation extremely difficult for taxpayers preparing their own returns. This complexity also calls into question the ability of the Internal Revenue Service (IRS) to audit compliance with the AMT. The inclusion of adjustments and preferences from pass-through entities also contributes to the complexity of the AMT system.

Effects of the Taxpayer Relief Act of 1997 and AMT on Individual Taxpayers.—If the Administration's budget proposal on temporary AMT relief expansion is not enacted, several tax credits included in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves subject to the alternative minimum tax (AMT). For many, this will come as a real surprise and, in all likelihood, will cause substantial problems for the IRS, which will have to redirect significant resources to this area in the future to ensure compliance, educate taxpayers, and handle taxpayer questions. We believe the Administration's proposal should be for permanent AMT relief rather than just temporary two-year relief.

Most sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers, however, may never have even heard of the AMT, certainly do not understand it, and do not expect to ever have to worry about it. Unfortunately, that is changing—and fairly rapidly—since a number of the more popular items, such as the education and child credits that were recently enacted, offset only regular tax and not AMT. Due to these changes, we believe it is most important that Congress obtain information (from Treasury, the Joint Committee on Taxation staff, or OMB) not only as to the revenue impact of the interaction of all these recent tax changes with the AMT, but also of the likely number of families or individuals that will be paying AMT as a result of the 1997 tax legislation.

Indexing the AMT Brackets and Exemption.—While the AICPA has not undertaken detailed studies, we have all seen, during the past year, anecdotal examples indicating the likelihood that taxpayers with adjusted gross incomes in the $60,000-$70,000 range (or below) will be subject to AMT. Aside from the fairness issues involved—this is not the group that the AMT has ever been targeted to hit—we see some potentially serious compliance and administration problems. Many of these taxpayers have no idea that they may be subject to the AMT (if, indeed, they are even aware that there *is* an AMT). Thus, we anticipate large numbers of taxpayers not filling out a Form 6251 or paying the AMT who may be required to do so, thus requiring extra enforcement efforts on the part of the IRS to make these individuals (most of whom will be filing in absolute good faith) aware of their added tax obligations. Further, IRS notices to these taxpayers assessing the proper AMT may well be perceived as unfair, subjecting the IRS to unfair criticism that should be directed elsewhere.

Individual AMT Recommendations.—We recognize that there is no simple solution to the AMT problem given the likely revenue loss to the government. As a start, however, Congress should consider:

1. Increasing and/or indexing the AMT brackets and exemption amounts.
2. Eliminating itemized deductions and personal exemptions as adjustments to regular taxable income in arriving at alternative minimum taxable income (AMTI) (e.g., all—or possibly a percentage of—itemized deductions would be deductible for AMTI purposes).
3. Eliminating many of the AMT preferences by reducing for all taxpayers the regular tax benefits of AMT preferences (e.g., require longer lives for regular tax depreciation).

4. Allowing certain regular tax credits against AMT (e.g., low-income tax credit, tuition tax credits)—permanently, rather than just for the next two years.

5. Providing an exemption from AMT for low and middle-income taxpayers with regular tax AGI of less than $100,000.

6. Considering AMT impact in all future tax legislation.

Due to the increasing complexity, compliance problems, and a perceived lack of fairness towards the intended target, an additional alternative Congress might also want to consider is eliminating the individual AMT altogether.

Contribution to Simplification of AMT.—The goal of fairness that is the basis for AMT has created hardship and complexity for many taxpayers who have not used preferences to lower their taxes but have been caught up in the system's attempt to bring fairness. Many of these individuals are not aware of these rules and complete their return themselves, causing confusion and errors. The 1997 law and the impact of inflation on indexed tax brackets and the AMT exemption are causing more lower income taxpayers to be inadvertently subject to AMT. Increasing and/or indexing the AMT brackets and exemption (recommendation 1) would solve this problem.

Under recommendation 2, those individuals who are affected only by itemized deductions and personal exemption adjustments would no longer have to compute the AMT. Itemized deductions are already reduced by the 3 percent AGI adjustment, 2 percent AGI miscellaneous itemized deduction disallowance, 7.5 percent AGI medical expense disallowance, $100 and 10 percent AGI casualty loss disallowance, and the 50 percent disallowance for meals and entertainment. Similarly, the phase out of exemptions already affects high-income taxpayers. It is also worth noting that because state income taxes vary, taxpayers in high income tax states may incur AMT solely based on the state in which they live, while other taxpayers with the same adjusted gross income (AGI), but who live in states with lower or no state income taxes, would not pay AMT. This results in Federal tax discrimination against residents of high tax states.

In addition, under recommendation 3, many of the AMT preferences could be eliminated by reducing for all taxpayers the regular tax benefits of present law AMT preferences (e.g., require longer lives for regular tax depreciation). This would add substantial simplification to the Code, recordkeeping and tax returns.

Under recommendation 4, those who are allowed regular tax credits, such as the low income or tuition tax credits, would be allowed to decrease their AMT liability by the credits. This would increase simplicity and create fairness. Compliance would be improved.

Under recommendation 5, fewer taxpayers will be subject to AMT and the associated problems. By increasing the AMT exemption to exclude low and middle income taxpayers, the AMT will again be aimed at its original target—the high-income taxpayer.

By eliminating AMT altogether, all the individual AMT problems would be solved.

Conclusion on AMT.—In conclusion, we see the AMT as becoming more prevalent and causing considerable disillusion to many taxpayers whom do not see themselves as wealthy and who will believe they are being punished unfairly. The AMT will apply to many taxpayers it was not originally intended to affect. We believe our proposals offer a wide range of ways to help address this problem.

I.B.2—Exclusion For Employer-Provided Educational Assistance

Section 127 allows workers to exclude up to $5,250 a year in employer reimbursements or direct payments for tuition, fees, and books for certain courses. This exclusion expires on June 1, 2000. The President's proposal would extend the Section 127 exclusion for eighteen months for both undergraduate and graduate courses.

We support extension of the Section 127 exclusion and encourage Congress to consider making it a permanent part of the tax code. We also support re-inclusion of graduate-level courses as expenses qualifying for the exclusion. Expanding and making Section 127 a permanent part of the tax code would remove the uncertainty and ambiguity that employees and employers now regularly face.

Evidence indicates that Section 127 has met the broad policy goals for which it was designed. It has provided incentive for upward mobility of employees who might not otherwise choose or be able to afford to return to school to improve their skills and educational qualifications. It has reduced complexity in the tax law because it does not require a distinction between job-related and non-job related educational assistance. Further, it has also reduced possible inequities among taxpayers by allowing lower-skilled employees, on a nondiscriminatory basis, eligibility for the exclusion without worry about the job-related test.

Complexity could be further reduced by making Section 127 permanent thereby eliminating the periodic rolling forward of the expiration date and the need for retroactive reinstatement. This is particularly troublesome to students who are planning a multi-year education program and cannot plan on consistent after-tax costs throughout their education. These students are often on a tight budget and find it difficult to plan for and implement full-degree programs.

The continued education and increased competence of the U.S. worker are critical to surpassing the challenges of an international marketplace.

I.F.13–17—PROMOTE EXPANDED RETIREMENT SAVINGS, SECURITY, AND PORTABILITY

The President's budget contains five provisions to increase pension portability, the ability to roll over retirement savings between pension plans. The AICPA supports these provisions and commends the Administration for addressing a complex area of the tax law that is becoming increasingly utilized given our mobile workforce. These provisions would simplify planning and reduce the pitfalls and penalties that taxpayers run afoul of in attempting to comply with the current rules.

Under the budget proposal:

An eligible rollover distribution from a qualified retirement plan could be rolled over to a qualified retirement plan, a Code section 403 (b) annuity, or a traditional IRA. Likewise, an eligible rollover distribution from a Section 403 (b) annuity could be rolled over to another Section 403 (b) annuity, a qualified retirement plan, or a traditional IRA. The conduit IRA rules would be modified similarly.

Individuals who have a traditional IRA and whose IRA contributions have been tax deductible would be allowed to transfer funds from their traditional IRA into their qualified defined benefit retirement plan or Section 403(b) annuity, provided that the retirement plan trustee meets the same standards as an IRA trustee.

After-tax employee contributions to a qualified retirement plan could be included in a rollover contribution to a traditional IRA or another qualified retirement plan, provided that the plan or IRA provider agrees to track and report the after-tax portion of the rollover for the individual. Distributions of the after-tax contributions would continue to be nontaxable.

Individuals would be permitted to roll over distributions from a governmental Section 457 plan to a traditional IRA.

State and local employees would be able to use funds from their Section 403 (b) annuities or government Section 457 plans to purchase service credits through a direct transfer without first having to take a taxable distribution of these amounts.

In addition, there are numerous other pension provisions from previous budget proposals which the AICPA supports. These provisions would: Make it easier for workers to contribute to IRAs through payroll deduction at work; provide a three-year small business tax credit to encourage them to start up retirement programs; create a new simplified defined benefit pension plan (The SMART Plan-Secure Money Annuity or Retirement Trust Plan); provide faster vesting of employer matching contributions; improve pension disclosure; improve benefits of non-highly compensated employees under Section 401 (k) safe harbor plans; simplify the definition of highly compensated employee; simplify full-funding limitations and Section 415 benefit limits for multi-employer plans, and eliminate partial termination rules for multi-employer plans. All of these provisions would assist taxpayers in setting up retirement plans and improve the overall rate of savings in the U.S.

The AICPA supports these recommendations and believes that Congress should consider further efforts to encourage retirement savings and investment, including making personal financial planning more available to employees through employee benefits plans.

I.H.7—SIMPLIFY THE ACTIVE TRADE OR BUSINESS REQUIREMENT FOR TAX-FREE SPIN-OFFS

The AICPA supports the Administration's proposal to improve the operation of Section 355. This is a longstanding one, well-known to the corporate tax community. Current law poses trouble for taxpayers: for the unwary, a trap; for the well-advised, sometimes a costly (and economically unproductive) detour.

The problem lies in the statute itself, which accommodates pure holding companies, but not hybrids. In applying the "active conduct" test to holding companies, Section 355(b)(2)(A) requires that "substantially all" of its assets consist of stock (and securities) of controlled subsidiaries that are themselves engaged in the "active conduct," etc. The "substantially all" requirement is not defined in either statute or regulations. The IRS has defined it, in the context of an advance ruling, as 90% of gross assets. This raises a very high threshold for holding companies, one that can be met only by pure (or virtually so) holding companies.

The unwary taxpayer will make a distribution to shareholders that may wind up as a tax controversy. The well-advised taxpayer will take a detour. The objective of the detour is to convert the hybrid holding company into an operating company. This can usually be accomplished, so long as the holding company has at least one controlled subsidiary that meets the "active conduct" test. For example, the holding company can cause the controlled subsidiary to be completely liquidated, so that the latter's active business is now operated directly by the holding company. From an economic perspective, this step is meaningless because it shouldn't matter whether a business is conducted directly or indirectly. But the step is a *tax* cure-all because, unlike a holding company, an operating company is not subject to a quantitative test. Rather, the latter is subject to a qualitative test: is it operating an active business?

There is no apparent reason for the statute's asymmetric approach to holding companies and operating companies, respectively. According to IRS advance ruling guidelines, at least 90% of a holding company's gross assets must be invested in qualifying assets, i.e., stock in controlled subsidiaries that are engage in the active conduct," etc. On the other hand, according to the IRS advance ruling guidelines, an operating company need have as little at 5% of its gross assets invested in the active business.

The Administration's proposal would address this lack of symmetry by treating an affiliated group as a single taxpayer. No longer would a hybrid holding company be forced to relocate an active business within its corporate family in order to meet the "active conduct" requirement. This amendment is entirely consistent with the prevailing, single-entity theory of consolidated returns, and it has our full support.

II.A.1–6—CORPORATE TAX SHELTERS

The President's budget contains sixteen proposals addressing "corporate tax shelters." The first six of these address the topic generically by imposing new penalties and sanctions and by establishing new tax rules to govern transactions generally. This section provides our comments on the six generic proposals. We expect to comment on some of the specific transaction rules separately in subsequent submissions after our technical committees have completed their reviews of the proposals.

We begin by recognizing that tax laws are usually followed, but that they can also be abused. Where there are abuses, we hold no brief for them—whether they fall under the pejorative rubric of "tax shelters" or any other part of our tax system. Thus, we sympathize with and support efforts to restrict improper tax activities through appropriate sanctions. Specifically, we favor the Administration's recommendation regarding exploitation of the tax system by the use of tax-indifferent parties.

However, we also support and defend the right of taxpayers to arrange their affairs to minimize the taxes they must fairly pay and, with that in mind, we have some serious concerns about where the President's proposals draw the distinction between legitimate tax planning and improper tax activities. We see them as an overbroad grant of power to the Internal Revenue Service to impose extremely severe sanctions on corporate taxpayers by applying standards that are far from clear and that could give examining revenue agents a virtual hunting license to go after corporate taxpayers (which, by the way include huge numbers of small and medium-sized businesses, not just Fortune 100 companies). This would seem to be inconsistent with the taxpayer rights thrust of last year's IRS restructuring legislation. In our view, the debate concerning the sanctions for improper corporate tax behavior must begin with a clear understanding of the standards that distinguish abusive transactions from legitimate tax planning. What standards justify the imposition of extraordinary punishment on a corporation (or tax adviser) whose tax treatment of a transaction is successfully challenged by the IRS?

Our primary concern with the Treasury proposals is the absence of a clear standard defining what is and what is not an abusive transaction, which would apply to most provisions of the tax law. The proposals modifying the substantial understatement penalty for corporate tax shelters and denying certain tax benefits to persons avoiding income tax as a result of "tax avoidance transactions" set forth a too-vague definition of abusive uses of the income tax laws that must be clarified. Anti-abuse legislation should be directed at transactions that are mere contrivances designed to subvert the tax law. The Treasury proposals move beyond the scope we think is appropriate to reach transactions that are described vaguely as "the improper elimination or significant reduction of tax on economic income." This criterion, whatever meaning is ascribed to it, is certain to capture transactions that would not be considered abusive by most and other transactions that have been undertaken for legitimate business purposes. We believe that greater clarity is possible, and would like to work with the staff to develop a clearer, more objective standard for identifying abusive transactions that can be used for most provisions of the tax code. A clearer standard would provide advantages to tax administrators and taxpayers alike by promoting consistency in its application. In addition, we would like to reverse the proliferation of highly subjective terms such as “significant,” “insignificant,” “improper,” and “principal” which are used in the Treasury proposals and current law. While we doubt that it is possible to eliminate them all, it would be a laudable goal to minimize their number.

While the crafting of a clear standard is indeed a difficult task, perhaps we can begin to approach the issue by trying to agree on what types of transactions should *not* be considered abusive. It should be considered a fundamental principle that Congress intended the income tax laws to apply to all transactions, without penalty, that either are undertaken for legitimate business purposes, or which further specific governmental, economic or social goals that were contemplated by discrete legislation. Therefore, a transaction undertaken for reasons germane to the conduct of the business of the taxpayer, or that is expected to provide a pre-tax return which is reasonable in relation to the costs incurred, or that reasonably accords with the purpose for which a specific tax incentive or benefit was enacted should not be considered abusive. While our discussion below criticizes the Treasury standard for abusive conduct, we do not have our own fully developed definition to propose to you at this time. However, we have asked a task force of our Tax Executive Committee to examine this issue and we are hopeful that we can submit our specific recommendations to you and to Treasury in a timely fashion. We would be pleased to have the opportunity to work with you and them to see if it is possible to develop a standard that could be used for most purposes of the Code.

The budget proposals provide punitive sanctions on “tax avoidance transactions,” and Treasury’s explanation of the proposals defines such transactions to include those where reasonably expected pre-tax profit is “insignificant” relative to reasonably expected tax benefits. It is the softness and inadequacy of this definition to deal with the breadth of the transactions swept into the sanctions, combined with the extreme nature of the weapons given the IRS, which create our concern that legitimate tax planning will also be caught up in this maelstrom. How does this concept apply, for example, to a host of business decisions that do not involve profit motive, but rather are to defer income or accelerate deductions? (We do recognize that there is a proposed exception under which a transaction would not be considered “tax avoidance” if the benefit is “clearly contemplated” by the applicable provision. However, “clear contemplation” is generally in the eye of the beholder, and if that contemplation is intended to reflect what Congress had in mind when the provision was passed, we would respectfully suggest that many provisions in our highly complex tax laws have no “clear” congressional contemplation.)

A second major concern (alluded to earlier) is that these proposals would result in an alarming shift in authority from Congress to the IRS. These proposals would result in a grant to the IRS of virtually unbridled discretion in the imposition of penalties and other sanctions—and this would come only one year after Congress had concluded there was a need to rein in an agency that had proved itself overzealous in pursuing taxpayers. The obscure manner in which the proposals define the term “tax avoidance transaction,” combined with the wide range of penalties and other sanctions that could be invoked upon a finding of such a transaction, would provide IRS auditors with enormous opportunities and incentives to assert the existence of “tax avoidance transactions” almost at will. Unfortunately, within a few years we would expect aggressive agents to use this weapon as a means of forcing corporate taxpayers to capitulate on other items under examination.

Our third concern is that the provisions are so broad they could negatively affect legitimate tax planning. Without backing away from our earlier point regarding abuses of the tax laws, appropriate planning to minimize taxes paid is still a fundamental taxpayer right that must be defended. “The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted...” (Gregory v. Helvering, 293 U.S. 465, 1935). We think the budget proposals provide so many powers to the government there is a real likelihood that, if enacted, they could prevent advisers and taxpayers from undertaking or considering tax-saving measures that are not abusive.

We are also concerned that increased and multiple penalties, based on a loosely defined standard and with no abatement for reasonable cause, should not apply in a subjective area where differences of opinion are the norm, not the exception. We believe that penalties should be enacted to encourage compliance with the tax laws, not to raise revenue. The enactment of new penalties must be carefully developed with consideration for the overall penalty structure and any overlaps with existing penalties. We also believe that there should be incentives for taxpayers to disclose tax transactions that could potentially lack appropriate levels of authority and that penalties should be abated with proper disclosure and substantial authority.

In this regard, it should be noted that the Joint Committee on Taxation and the Treasury Department are undertaking independent studies of the entire tax penalty structure, at the request of the Congress. The AICPA has recently submitted numerous comments about the penalty administration system to the Joint Committee and Treasury, and we have commented a number of times in the past few years that, the penalty system has become more difficult to administer in the past decade. We favor a review, de novo, of the penalty system, and we would suggest (as part of that review but also for purposes of the current hearing) that merely adding new or increased penalties to the law whenever Congress or the Administration wishes to curtail taxpayer activity is not the proper answer. The result is inevitable taxpayer confusion and a higher likelihood that the penalty system cannot be administered consistently by the IRS (with resulting inequities among taxpayers).

The Administration has proposed a large variety of financial sanctions on transactions that are ultimately determined to permit "tax avoidance." These include a doubling of the substantial understatement penalty to 40%, an extension of that penalty at 20% to fully disclosed positions, the ability of the IRS to disallow any tax benefits derived from the transaction, disallowance of deductions for fees paid to promoters or for tax advice about the transaction, and an excise tax of 25% on the amount of such fees received. In addition, no "reasonable cause" exception will exist to argue against the penalty part of any deficiency. Since (as we discuss below) there is little incentive for disclosure in these proposals, the 40% substantial understatement penalty plus the 35% corporate tax rate on disallowance of any tax benefit, will produce a 75% tax cost (in addition to the economic costs) for entering such a transaction—indeed a significant deterrent. For the part of the deficiency attributable to fees or tax advice, an additional 25% excise tax is imposed, for a 100% tax cost (or "only" 80% if there is full disclosure under the terms of the proposals)—again, with no "reasonable cause" exception.

We would note that these amounts equal or exceed the tax penalty for civil fraud (75%). Thus, enactment of the President's proposals would single out these transactions as equal to or worse than civil tax fraud. We recognize there may be those who believe that tax avoidance transactions *are* the equivalent of civil tax fraud and deserve this level of sanction. However, we would also note that the due process requirements for showing civil fraud are vastly higher than for tax avoidance transactions. For example, the government bears the burden of proof for showing civil fraud; for assessing sanctions on a tax avoidance transaction, the burden of proof is on the taxpayer (it may or may not shift to the government if the case is litigated, depending on the size of the corporation and the development of the administrative proceeding). Further, for tax avoidance transactions, these proposals would legislate away the ability of a taxpayer to argue that the position was taken in good faith and there was reasonable cause for the taxpayer to act as it did.

While respecting the views on the other side, we do not believe the case has been made that tax avoidance transactions (under the loose proposed standard discussed above) rise to the level of civil fraud. We certainly do not understand why the due process requirements in place for civil fraud are absent here.

With further respect to the issue of promoters and tax advisers, the fee disallowance and excise tax recommendations imply that there are presently inadequate deterrents in the law for those who advise on "abusive" corporate transactions. We would like to suggest that consideration be given to whether changes in Circular 230 (the Treasury regulations governing the right to practice before the IRS) could be a more effective answer to some of these problems rather than another tax and added penalties (on the disallowance of adviser fees). We recognize that Circular 230 would not apply as presently written to some promoters, but there have been some proposals in recent months regarding potential changes in Circular 230 that may be appropriate for consideration. In addition, preparer and promoter penalties under current law could be reviewed for adequacy.

We do not agree with the proposal that precludes taxpayers from taking tax positions inconsistent with the form of their transactions—but not because we believe taxpayers should be able to casually disavow the form. However, the Joint Committee on Taxation analysis of this provision raises several issues that we believe should be addressed. At this point, we are not convinced that the tax law or system of tax administration would be improved by this provision. Given the abundance of existing case law on this issue, it is not clear to us why new legislation is required at this time.

One final concern: if the Treasury is concerned that the current disclosure rules may not be effective, we are prepared to address the question of when and what form of disclosure should be required in order to identify the types of transactions with which the Administration is concerned. However, we question the lack of incentives for disclosure both under current law and the President's proposals. The Administration's disclosure proposals come on top of registration requirements that were enacted only a year ago (on which we are still awaiting regulations). For those affected by the previous registration requirements, this proposal would be overkill (requiring disclosure for registration purposes with the IRS as the transaction begins to be marketed, and additional disclosure to the IRS within 30 days of closing a transaction). We believe that provisions that do not aid the tax administrator but add tremendous burdens to preparers and taxpayers should be eliminated. We stand ready to work with you and the IRS on this issue.

Today, we can do no more than offer our first impressions of these proposals. Our analysis and study has just begun as these proposals and the areas of law which they affect are necessarily complex. However, we are prepared to devote the effort necessary to complete a full, careful and timely review in this area, to offer you our best recommendations and to work with you and your staffs to develop improvements in the law that can and should be made to deal with identified problem areas.

II.B.2—REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT BY ACCRUAL METHOD TAXPAYERS

The administration's proposal would require accrual method taxpayers to include market discount in income as it accrues. The accrual would be limited to the greater of the original yield to maturity or the applicable federal rate, plus 5%. Under current law, a taxpayer is only required to include market discount in income when cash payments are received. Alternatively, a taxpayer may elect to currently include market discount in income. The AICPA does not support the administration's proposal regarding market discount for the reasons enumerated below.

Market discount may, in many circumstances, be economically equivalent to original issue discount ("OID"). In many situations, however, market discount may arise solely because of a decline in the credit-worthiness of the borrower and the resulting discount is not related to the time value of money. For this reason, the current market discount regime protects taxpayers from including in taxable income market discount that may very well never be collected. The Administration's proposal that market discount be accrued in an amount up to the greater of the original yield to maturity or the applicable federal rate, plus 5%, would, in many instances, require a taxpayer to accrue income that may very well never be collected.

The IRS and Treasury, to date, have not issued comprehensive guidance on how taxpayers should accrue interest, market discount and original issue discount on debt obligations where there is substantial uncertainty that the income will be collected. Accordingly, the mandatory accrual of market discount should not be required until guidance on non-accrual of discount is released.

The Administration is proposing to require the current accrual of market discount. A similar requirement exists for original issue discount. However, while substantial guidance has been issued in the form of Treasury Regulations and other published guidance with regard to OID, no such guidance has been issued under the market discount provisions. As a result, taxpayers have been struggling with complex market discount provisions contained in the code since 1984 but with no guidance on how to apply the provisions. The AICPA believes that, substantive guidance should be issued to instruct a taxpayer exactly how to apply these provisions. Substantive guidance is needed to address the accrual of market discount in several areas, including, but not limited to, (1) obligations subject to prepayment; (2) obligations that become demand obligations after the original issue date; and (3) obligations purchased at significant discounts because of a decline in the credit rating of the issuer. Until such guidance is issued, the AICPA does not believe it is prudent to require the current accrual of market discount.

This proposal, if enacted, would expand complex tax rules applicable to sophisticated financial transactions to a broad universe of taxpayers. As it is, taxpayers are faced with a myriad of questions when determining how market discount is deemed to accrue. Thus, it is unrealistic to expand a complex regime to a broader universe of taxpayers without first issuing guidance with respect to the original provisions. For example, it is common for a taxpayer to hold a market discount obligation with OID. In this circumstance, most taxpayers will have to perform three computations to determine income with respect to these obligations, one for financial accounting purposes, one for tax purposes with respect to the OID and one for tax purposes regarding market discount. Even taxpayers "familiar with the complexities of reporting income under an accrual method" would find this burdensome.

Any perceived abuse by the administration that taxpayers are able to achieve a deferral by not recognizing market discount currently is unfounded as well. Many taxpayers (such as financial institutions) that hold market discount obligations use debt to purchase and carry such obligations. Generally, such taxpayers cannot deduct interest expense incurred to purchase and carry the market discount obligations thereby eliminating, much if not all, of the benefit resulting from the deferral of market discount.

II.D.4—Repeal of Tax-Free C-to-S Conversions

The AICPA continues to strongly oppose the Administration's proposal to treat the conversion of a so-called "large" (greater than $5 million in value) C corporation to an S corporation as a taxable liquidation. The Administration's proposal also in effect would impose a new "merger tax" on certain acquisitions of C corporations by S corporations. We continue to believe that the proposal is short-sighted, would be harmful to small business, and is grossly inconsistent with Congressional efforts to reform Subchapter S to make it more attractive and more workable. We are pleased that the Congress has consistently rejected this included in the Administration's previous budget recommendations.

This proposal would repeal the section 1374 built-in gains tax for corporations whose stock is valued at more than $5 million when they convert to S corporation status. In place of the section 1374 built-in gains tax, which would tax built-in gains if and when built-in gain property is disposed of during the ten-year period after conversion, the proposal would require such converting corporations to recognize immediately all the built-in gain in their assets at the time of conversion. The proposal would be effective for conversions for taxable years beginning on or after January 1, 2000.

The AICPA strongly opposes this proposal. We believe this proposal constitutes a major change in corporate tax law, and one that would be contrary to sound tax policy. As stated above, we believe that any significant change affecting Subchapter S should only be undertaken pursuant to a comprehensive review and not be the subject of piecemeal changes designed primarily to attain revenue goals.

Current section 1374 is designed to preserve a double-level tax on appreciation in assets that accrued in a corporation before it elected S corporation status. To accomplish this, section 1374 subjects S corporations to a corporate-level tax on asset dispositions during the ten years following conversion. Section 1374's primary purpose is to prevent a C corporation from avoiding the 1986 Tax Reform Act's repeal of the *General Utilities* doctrine, by converting to S corporation status prior to a sale of its business. Since its enactment, section 1374 has been refined several times in order to strengthen its operation, such as the addition of a suspense account mechanism to prevent built-in gains from escaping tax due to the taxable income limitation. The experiences of our members indicate section 1374 is effective in achieving its purpose. We see no reason to abandon this mechanism.

The proposal also is counter to well-established policy regarding the tax treatment of the conversion of C corporations to S corporation status. For example, in 1988, Section 106(f) of S. 2238 and Section 10206 of H.R. 3545, the then-pending Technical Corrections Bill, would have modified the computation of the built-in gains tax by removing the taxable income limitation. This provision was ultimately rejected under "wherewithal to pay" principles. At that time, the AICPA's position was articulated in the following passage from a letter from then Chairman of the AICPA Tax Division, Herbert J. Lerner, to the Honorable Dan Rostenkowski; this statement continues to reflect the position of the AICPA:

> Perhaps of even greater long-term concern is that this technical correction seems to be yet another manifestation of a fundamental change in tax philosophy. Several staff members from the tax writing committees have told us that they believe that any conversion from C to S status should be taxed as though the corporation had been liquidated and a new corporation formed. We believe that this is not sound tax policy and that it would be contrary to the underlying purpose of Subchapter S which has been widely used by small businesses for some 25–30 years. ... This liquidation philosophy is a major change in tax policy and should be debated as such, should be subject to public hearings and should not be allowed to creep into the law through incremental changes.

It is noted that a similar attempt to repeal the taxable income limitation for elections made after March 30, 1988 was rejected by Congress in 1992 (Section 2 of H.R. 5626). A legislative proposal to effectively treat the conversion as a liquidation was also rejected by Congress in 1982.

The AICPA believes that the proposal under consideration would effectively repeal the availability of Subchapter S for so-called "large" corporations (*i.e.*, corporations valued at over $5 million). As noted, the proposal would require such corporations to be taxed immediately on all unrealized gain in their assets, including goodwill, and to pay a tax on this gain. For large corporations with significant unrealized value, the cost of conversion would be exceedingly expensive and, therefore, Subchapter S status would in effect be rendered completely inaccessible to them. As a result, the proposal would generally leave Subchapter S status available only to those large corporations with either little or no built-in gain or sufficient net operating loss carryovers to offset the gain. We do not believe that restricting the benefits of Subchapter S to this latter class of C corporations represents sound tax policy.

A further objection we have to the proposal is the use of the $5 million fair market value threshold for determining the applicability of the tax. Basing the applicability of the provision, which could have devastating tax consequences, on such a subjective benchmark is simply untenable. If a corporation wished to convert to S corporation status, how could it conclusively determine whether or not the immediate taxation of built-in gains would apply? Even if the corporation incurred the cost of obtaining an appraisal, how would the corporation be sure the valuation would not later be challenged by the Internal Revenue Service? As a pure business matter, many corporations simply would not be willing to accept any significant level of uncertainty regarding this potentially devastating tax on paper gains. Adding such a burdensome and uncertain provision to the tax law clearly would be contrary to sound tax policy.

In summary, the AICPA feels strongly that the proposal to repeal section 1374 for large corporations and impose an immediate tax on all unrealized gain in their assets runs counter to long-standing tax policy which Congress has adhered to for many years. Further, although the proposal may serve the purpose of raising revenue, it would do so to the detriment of certainty and fairness in the tax law. The proposal would effectively eliminate new conversions to Subchapter S status for most corporations valued at more than $5 million; such a major change in the tax law should not be made without careful analysis. We, therefore, strongly urge you to remove the proposal from consideration.

II.E.5—Repeal the Lower of Cost or Market Inventory Accounting Method

This proposal would eliminate the use of the lower of cost or market method for federal income tax purposes. This proposal has been made on a number of occasions in the past, and the AICPA has opposed each such proposal.

We continue to oppose this proposal. This method has been accepted in the tax law since 1918 and is an integral part of generally accepted accounting principles (GAAP). LCM conformity with GAAP does provide some needed simplicity. Further, there is no reason why this method should suddenly become impermissible. It is not a one-sided application of mark-to-market because once a taxpayer lowers the selling price of its goods below their cost, the taxpayer is not going to realize a profit on the eventual sale of the goods.

We are disappointed that a widely established and universally used tax accounting method, which finds its genesis in generally accepted accounting principles, would—after having been a part of our tax structure for over 80 years—be proposed for repeal. The process is particularly unfortunate because, when all is said and done, the LCM repeal proposal involves a *timing* difference only, rather than a truly substantive change in tax policy. At the end of the day, the issue becomes whether components of inventory transactions are recorded on a return this year or next year; there is no issue as to whether they will ever be recorded at all.

Now, suddenly, Congress is asked to change a basic tax rule that predates almost all of us. Taxpayers will have to live with this change for decades or longer. On that basis, particularly for an issue that involves only timing, it is particularly distressing to see the change occur under this process. One would think that 76 years of totally accepted usage is precedential enough to warrant a more deliberate process for its removal from the law.

Without wishing to detract from our main point—LCM should *not* be repealed—let us note that if Congress determines to eliminate lower of cost or market, there needs to be a small business exception in the interest of simplicity. Many small businesses (particularly those meeting the retail de minimis exception to the uniform capitalization rules) are currently able to use their financial statement inventory numbers on their tax returns. Since the LCM method will still be required for financial reporting, it will no longer be possible for these taxpayers to use financial statement inventory on their returns. Market writedowns will have to be segregated for proper reporting as a book-tax difference. Thus, especially for small business, there will be a disproportionate additional cost of compliance on top of the added tax cost for not being able to use LCM.

We believe, therefore, it is imperative that there be a *meaningful* small business exception if LCM is repealed. The Administration proposal includes a small business exception modeled on present Code section 448 (ability to use the cash basis of accounting), which holds that the provisions are not applicable to businesses that average less than $5 million annual gross receipts (not to be confused with gross income, which can be a substantially lower number) over a three-year period. Since, however, we are considering an inventory method change, and inventories generally turn over several times a year, it could be a very small business indeed which meets a $5 million gross *receipts* test. Accordingly, we think it essential that, if a gross receipts exemption is used, it should be at least at the $10 million level, rather than $5 million. In fact, the most recent de minimis statutory rule involving inventories is the so-called "retail exception" in the uniform capitalization rules, and it is at a $10 million gross receipts level. Alternatively, Congress might consider a $5 million gross *income* de minimis rule (which would be gross receipts less cost of sales).

II.H.1—Subject Investment Income of Trade Associations to Tax

The President's budget proposals would impose a corporate-rate tax on "net investment income" of section 501(c)(6) organizations (trade associations and other business leagues). Our comments on this proposal are clearly made in our members' interests as well as for tax policy reasons: the AICPA is a section 501(c)(6) organization and it does have investment income which would be subject to this new proposed tax.

Nonetheless, we question the policy basis on which the proposals are being put forth. It is implied that current law provides an incentive to fund association operations on a tax-free basis (through the build up of non-taxed investment assets) because members receive a deduction for dues payments but would have been taxed on the earnings attributable to those payments had the payments not been made to a 501(c)(6) organization. Thus, according to the *Treasury Department General Explanation of the Administration's Revenue Proposals*, members are "avoiding tax" on the earnings from their dues.

While we understand the theoretical basis for this argument, it just does not comport with business reality. No business is going to view dues payments to a trade association as a prudent means of sheltering income from tax, on the grounds that earnings on the payments are tax free if for the account of the association but taxable if for the account of the member. In order to get the benefit of this "shelter," the member has to actually pay over money to the association, which puts those funds absolutely outside the members' control—a fairly ludicrous business decision if the thinking behind the extra or advance payment is the avoidance of income tax.

We would also note that associations accumulate surplus not to accelerate deductions or provide tax deferrals, but because it is prudent business practice. By providing cushions against membership fall-off in times of economic decline, for example, an association is able to protect against annual dues fluctuations. And, as an organization which relies predominantly on member dues to fund its exempt purposes, the AICPA is very much aware of member sensitivity to annual changes in dues. Associations need to provide a stable dues structure to smooth out member fall-off and increases from year to year (which, in turn, affects the association's annual operating budget for its normal activities). Further, prudence dictates that there be some cushion available for unanticipated business issues that arise during a year. (We do recognize that there is a $10,000 exemption from the proposed tax, but that amount applies equally to associations with 250 members and 250,000 members. Even for taxable entities (corporations), the Code permits earnings to be accumulated for the "reasonable needs of the business" before a penalty tax is imposed.)

Finally, we note that the Joint Committee on Taxation has estimated this provision as a $698 million revenue raiser over five years and a $1.6 billion revenue raiser over ten years. We do not know the basis of those revenue estimates, but we would point out that for any association that becomes subject to this additional tax, it will either have to curtail services to members or raise member dues to fund the tax. Those dues increases will result in additional deductible payments by members, with a concomitant reduction in federal revenues.

II.I.6—Eliminate Non-business Valuation Discounts

The administration's proposal would eliminate valuation discounts except as they apply to active businesses. This proposal is built upon the presumption that there is no reason other than estate tax avoidance for the formation of a family limited partnership (FLP). We disagree. There are any number of other reasons why a taxpayer might wish to set up an FLP including: management of assets in case of incompetency, increased asset protection, the reduction of family disputes concerning the management of assets, to prevent the undesired transfer of a family member's interests due to a failed marriage, and to provide flexibility in business planning not available through trusts, corporations or other business entities.

The beneficiaries of FLPs do not receive control over the underlying assets and generally have no say as to the management of those assets. Individuals receiving non-public, non-tradeable interests in a legally binding arrangement are not in as good a position as they would have been if they had received the underlying assets outright. Substantial economic data indicate that the value of these interests is less than the value of the underlying assets. Valuation discounts are a legitimate method of recognizing the restrictions faced by holders of FLP interests.

The wholesale change to the taxation of these entities is unreasonable and too broad. It assumes that FLPS are used only to avoid transfer taxes and disregards the non-tax reasons for their formation and the fact that these non-tax reasons do reduce the value of these interests to owners. In addition, the Internal Revenue Service already has tools to combat abuses in this area including valuation penalties, disclosure requirements on gift tax returns, and the ability to examine the business purpose of FLPs.

II.I.7—Eliminate Gift Tax Exemption for Personal Residence Trusts

The administration's proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantor retained interest would be valued at zero for gift tax purposes.

The reasons for change include the inconsistency in the valuation of a gift made to a remainderman in a personal residence trust and in transactions not exempt from section 2702 and that the use value of a residence is a poor substitute for an annuity or unitrust interest. Because the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence, the administration contends that the actuarial tables overstate the value of the grantor's retained interest in the property.

In reply to the proposal, we would note that the present rules pertaining to personal residence trusts were enacted by Congress in 1990 as a specific statutory exception to the general rules of section 2702 to provide a mechanism for taxpayers to transfer a personal residence to family members with minimal transfer tax consequences. The proposal ignores the longstanding protected and preferred status the personal residence has held throughout the tax code. Examples of this status include the exemption provided to personal residences at the time section 2702 was originally enacted, maintenance of the itemized deduction for real estate taxes and mortgage interest on personal residences as provided in the Tax Reform Act of 1986 and the homestead exemption provided in the bankruptcy statutes. The acquisition and ownership of the personal residence has long been acknowledged as being central to the "realization of the American dream" and should continue to be protected and encouraged. In fact, it can be argued that the personal residence, or at least some portion of the value thereof, should be excluded from the transfer tax base altogether.

In addition, we dispute the contention that the use value of a residence is significantly less than the value of an annuity or unitrust interest. Commonly, real estate investments are predicated upon an assumed return (capitalization rate) ranging from 12%–15%. Even allowing for the payment of insurance, maintenance and property taxes expenses by the grantor and considering also that residential real estate appreciates on average by approximately 2% per year, it can be argued that the use value of the residence should be 7%–10% of the value of the property. As such, it can be argued that the actuarial tables do, in fact, assign an appropriate value to the grantor's retained interest.

The current law does not permit abusive application of the personal residence trust technique. Recently finalized regulations (Reg. Sec. 25.2702–5) prohibit the sale of the residence back to the grantor thus eliminating use of the technique as a means to circumvent the rules regarding GRATs and GRUTs. Furthermore, restrictions on the amount of property adjoining the residence which may be placed into a personal residence trust eliminate the technique as a means to transfer investment real estate on a tax-protected basis.

II.L.2 and 4—Compliance Provisions Relating to Penalties

We take no position the merits of these proposals, but oppose their enactment before completion of the penalty studies being conducted independently by the Joint

Committee on Taxation and the Department of the Treasury. As was noted when Congress last overhauled our penalty system in 1989, a piecemeal approach to enacting penalties over the years causes a complex collection of penalties that are not rationally related to a taxpayer's conduct and not understood by taxpayers. This does not encourage taxpayers to modify their behavior in the intended way, and causes taxpayer frustration when applied.

With penalty studies already underway, we believe these provisions should be studied and considered as part of overall penalty reform legislation. Deferring enactment now would help assure that these penalties were consistent and rational in a reformed penalty system and could avoid a possible extra round of penalty changes in these areas. The AICPA has commented to Treasury on its penalty study and would be happy to work with Congress to develop a simple, fair and rational penalty system.

II.L.3—Repeal Exemption for Withholding on Certain Gambling Winnings

We disagree with the proposal to require withholding on bingo and keno winnings in excess of $5,000. Because gambling winnings are taxable only to the extent that they exceed gambling losses, this proposal could result in over-withholding by not taking into account gambling losses, particularly for smaller "winners." The currently required reporting of these winnings on Form 1099 should be sufficient to promote and track compliance in most cases. For the unusual large winner, say $100,000 or more, withholding would more likely be appropriate.

Chairman Archer. Thank you, Mr. Lifson. We will be looking carefully at all of your written suggestions and criticisms. Mr. Olson, if you will identify yourself for the record, you may proceed.

STATEMENT OF MICHAEL S. OLSON, CERTIFIED ASSOCIATION EXECUTIVE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

Mr. Olson. Thank you, Mr. Chairman, distinguished Members of the Committee. My name is Michael Olson. I am president and chief executive officer of the American Society of Association Executives. ASAE is an individual membership organization made up of approximately 25,000 association executives and associate members who are managing over 11,000 of America's trade associations and professional societies.

And I am here representing that membership today, Mr. Chairman, opposing the specifics of the budget proposal submitted by the Clinton administration that would tax the net investment income of the 501(c)(6) association community to the extent their net income exceeds $10,000 a year.

It does this by subjecting the income to the unrelated business income tax, or UBIT. Income that would be subject to taxation, however, is not as narrow as one might expect from the administration term investment income. It actually includes virtually all passive income, including rent, royalties, capital gains, interest, and dividend revenues.

America's trade, professional, and philanthropic associations are an integral part of our society in this country. They allocate one of every four dollars they spend to member education and training, and public information activities in their respective communities. These same associations fuel America's prosperity by pumping billions of dollars into the economy and creating literally hundreds of thousands of jobs.

Importantly, associations perform many quasigovernmental functions. These include the areas of product performance and safety standards, continuing education, public information, professional standards, ethics, research, statistics, political education, and community service.

Without associations, the government and other institutions would face added and expensive burdens in order to perform these very essential functions.

The administration has suggested that its proposal would only affect a small percentage of associations, that it only applies to lobbying organizations, and that it somehow provides additional tax benefits to those members who pay dues to these associations.

Every one of these assertions is misleading and incorrect. ASAE estimates that this proposal will tax virtually all associations with annual operating budgets as low as $200,000 a year, hardly organizations of considerable size. In fact, the bulk of the organizations affected by this proposal would include associations at the State and local level, many of whom perform little if any lobbying functions.

Furthermore, existing law already eliminates any tax preference, benefit, or subsidy for the lobbying activities of these organizations. The primary argument the administration has used to support its proposal is that members of these (c)(6) organizations somehow have come up with a scheme to prepay their dues in order to enjoy a tax-free return on the investment. This argument, quite frankly, is absurd.

There is every incentive for trade and professional associations to keep their membership dues as low as possible, and to suggest that members wish to be overcharged in order to somehow enjoy a tax-free return on investment is both illogical and unrealistic. Furthermore, there is no way that the suspected investment strategy could benefit members since 501(c) organizations are prohibited from paying dividends, not to mention the prohibition against any individual inurement.

In many ways, this proposal attacks the basic tax-exempt status of associations and runs counter to the demonstrated commitment of Congress to furthering the purposes of tax-exempt organizations. The administration has singled out 501(c)(6) organizations, although there are 25 categories of 501(c) organizations. And they propose to treat them in the same manner as social clubs, which are organized for the private benefit of individual members.

If Congress enacts this proposal, it will alter in a fundamental way the tax policy that has governed the tax-exempt community for nearly a century and will set a dangerous precedent for further changes in tax law for all tax-exempt organizations.

In closing, Mr. Chairman, I would like to say to you and the Committee Members how tremendously pleased I and ASAE as an organization are that 28 Members of this Committee have written to the Chairman and Ranking Member expressing their opposition to this specific administration proposal, and we hope you would make that a part of the record along with our testimony.

Thank you for your courtesy, sir.

[The prepared statement follows:]

Statement of Michael S. Olson, Certified Association Executive, President and Chief Executive Officer, American Society of Association Executives

Mr. Chairman, my name is Michael S. Olson, CAE. I recently became the President and Chief Executive Officer of the American Society of Association Executives (ASAE). ASAE is an individual membership society made up of 24,700 association executives and suppliers. Its members manage more than 11,000 leading trade associations, individual membership societies, and other voluntary membership organizations across the United States and in 48 countries around the globe. ASAE also represents suppliers of products and services to the association community.

I am here to testify in strong opposition to the budget proposal submitted to Congress by the Clinton Administration that would tax the net investment income of Section 501(c)(6) associations to the extent the income exceeds $10,000 annually. Income that would be subject to taxation, however, is not as narrow as would be expected from the characterization in the proposal of "investment income" but includes all "passive" income such as rent, royalties, interest, dividends, and capital gains. This provision, which is estimated by the Treasury Department to raise approximately $1.4 billion dollars over five years, would radically change the way revenue of these tax-exempt organizations is treated under federal tax law. In addition, if enacted this proposal would jeopardize the very financial stability of many Section 501(c)(6) organizations.

America's trade, professional and philanthropic associations are an integral part of our society. They allocate one of every four dollars they spend to member education and training and public information activities, according to a new study commissioned by the Foundation of the American Society of Association Executives. ASAE member organizations devote more than 173 million volunteer hours each year—time valued at more than $2 billion—to charitable and community service projects. 95 percent of ASAE member organizations offer education programs for members, making that service the single most common association function. ASAE member associations are the primary source of health insurance for more than eight million Americans, while close to one million people participate in retirement savings programs offered through associations.

Association members spend more than $1.1 billion annually complying with association-set standards, which safeguard consumers and provide other valuable benefits. Those same associations fuel America's prosperity by pumping billions of dollars into the economy and creating hundreds of thousands of good jobs. Were it not for associations, other institutions, including the government, would face added burdens in the areas of product performance and safety standards, continuing education, public information, professional standards, ethics, research and statistics, political education, and community service. The work of associations is woven through the fabric of American society, and the public has come to depend on the social and economic benefits that associations afford.

The Administration has suggested that their proposal would only affect a small percentage of associations, that it is targeted to larger organizations, that the proposal targets "lobbying organizations," and that it somehow provides additional tax benefits to those who pay dues to associations. All of these assertions are misleading, ill-informed and incorrect.

Based on information from ASAE's 1997 Operating Ratio Report, this proposal will tax most associations with annual operating budgets as low as $200,000, hardly organizations of considerable size. In fact, the bulk of the organizations affected would include associations at the state and local level, many of whom perform little if any lobbying functions. Furthermore, existing law, as outlined below, already eliminates any tax preference, benefit, or subsidy for the lobbying activities of these organizations, and can even unduly penalize their lobbying.

The primary argument the Administration has used to support its proposal is that members of Section 501(c)(6) organizations prepay their dues in order to enjoy a tax-free return on investment. This argument, quite frankly, is absurd and is discussed below in full. There is every incentive for trade and professional associations to keep dues as low as possible for obvious reasons, and to suggest that members wish to be overcharged in order to somehow enjoy a tax-free return on investment is both illogical and unrealistic. Furthermore, there is no way that this suspected investment strategy could benefit members since Section 501(c)(6) organizations are prohibited from paying dividends.

In many ways, this proposal attacks the basic tax-exempt status of associations, and runs counter to the demonstrated commitment of Congress to furthering the purposes of tax-exempt organizations. These exempt purposes, such as training, standard-setting, and providing statistical data and community services, are supported in large part by the income that the Administration's proposal would tax and thereby diminish. If Congress enacts this proposal, it will alter in a fundamental way the tax policy that has governed the tax-exempt community for nearly a century, and will set a dangerous precedent for further changes in tax law for all tax-exempt organizations.

I would now like to review more completely the existing tax law governing this area, and to specifically address some of the arguments that have been made in support of the Administration's proposal. I believe that a careful consideration of the issues involved will make the Committee conclude that this proposal is both ill-advised and ill-conceived, and should be rejected.

I. TAXATION OF SECTION 501(C)(6) ORGANIZATIONS UNDER CURRENT LAW.

Section 501(c)(6) organizations are referred to in the tax law as "business leagues" and "chambers of commerce." Today they are typically known as trade associations, individual membership societies, and other voluntary membership organizations. These organizations are international, national, state, and local groups that include not only major industry trade associations but also small town merchants' associations or the local Better Business Bureau. Currently, the tax law provides that Section 501(c)(6) organizations are exempt from federal taxation on income earned in the performance of their *exempt* purposes. Associations engage primarily in education, communications, self-regulation, research, and public and governmental information and advocacy. Income received from members in the form of dues, fees, and contributions is tax-exempt, as are most other forms of organizational income such as convention registrations and publication sales. However, Section 501(c)(6) groups and many other kinds of exempt organizations are subject to federal corporate income tax on revenues from business activities unrelated to their exempt purposes (";unrelated business income tax" or "UBIT"). UBIT is applicable to income that is earned as a result of a regularly-carried-on trade or business that is not substantially related to the organizations' tax-exempt purposes. Section 501(c)(6) organizations are also subject to specific taxes on any income they spend on lobbying activities.

The UBIT rules were designed to prevent tax-exempt organizations from gaining an unfair advantage over competing, for-profit enterprises in business activities unrelated to those for which tax-exempt status was granted. Congress recognized, however, that Section 501(c)(6) tax-exempt organizations were not competing with for-profit entities or being unfairly advantaged by the receipt of tax-exempt income from certain "passive" sources: rents, royalties, interest, dividends, and capital gains. Tax-exempt organizations use this "passive" income to further their tax-exempt purposes and to help maintain modest reserve funds—to save for necessary capital expenditures, to even out economic swings, and the like. Indeed, the legislative history regarding UBIT recognizes that "passive" income is a proper source of revenue for charitable, educational, scientific, and religious organizations [Section 501(c)(3) organizations], issue advocacy organizations [Section 501(c)(4) organizations], and labor unions and agricultural organizations [Section 501(c)(5) organizations], as well as trade associations, individual membership societies, and other voluntary membership organizations [Section 501(c)(6) organizations].

Therefore, Congress drafted the tax code to expressly provide that UBIT for most tax-exempt organizations does not extend to "passive" income. As a result, exempt organizations such as associations are not taxed on rents, royalties, dividends, interest, or gains and losses from the sale of property. The proposal to tax "net investment income" of Section 501(c)(6) organizations would allow the IRS to impose a tax on all such previously untaxed sources of "passive" income. Contrary to its denomination, the scope of the tax is clearly much broader than just "investment income."

II. TAXATION OF SECTION 501(C)(6) ORGANIZATIONS UNDER THE ADMINISTRATION BUDGET PROPOSAL: TREATING PROFESSIONAL ASSOCIATIONS LIKE SOCIAL CLUBS.

Under the Administration's proposal, Section 501(c)(6) organizations would be taxed on all "passive" income in excess of $10,000. This proposed tax would not be imposed on exempt income that is set aside to be used exclusively for charitable and educational purposes. Funds set aside in this manner by Section 501(c)(6) organizations could be taxed, however, if those funds are ultimately used for these purposes. In addition, the proposal would tax gains realized from the sale of property used in the performance of an exempt function unless the funds are reinvested in replacement property.

Essentially, the budget proposal would bring Section 501(c)(6) organizations under the same unrelated business income rules that apply to Section 501(c)(7) social clubs, Section 501(c)(9) voluntary employees' beneficiary associations, and Section 501(c)(20) group legal services plans. These organizations receive less favorable tax treatment due to Congress' belief that they have fundamentally different, and less publicly beneficial purposes than other tax-exempt organizations. The Clinton Administration proposes to equate trade associations, individual membership societies, and other such voluntary membership organizations with country clubs, yacht clubs, and health clubs.

Social clubs, for example, are organized under Section 501(c)(7) for the pleasure and recreation of their individual members. As case law and legislative history demonstrate, social clubs were granted tax exemption not to provide an affirmative tax benefit to the organizations, but to ensure that their members are not disadvantaged by their decision to join together to pursue recreational opportunities. Receiving income from non-members or other outside sources is therefore a benefit to the individual members not contemplated by this type of exemption.

With regard to associations exempt under Section 501(c)(6), however, Congress intended to provide specific tax benefits to these organizations to encourage their tax-exempt activities and public purposes. These groups are organized and operated to promote common business and professional interests, for example by developing training material, providing volunteer services to the public, or setting and enforcing safety or ethical standards. In fact, the tax code prohibits Section 501(c)(6) organizations from directing their activities at improving the business conditions of only their individual members. They must enhance entire "lines of commerce;" to do otherwise jeopardizes the organizations' exempt status. Social clubs have therefore long been recognized by Congress as completely different from professional associations, engaged in different activities that merit a different exempt status.

Social clubs have always been taxed differently from associations. This reflects their different functions. Social clubs are organized to provide recreational and social opportunities to their individual members. Associations are organized to further the interests of whole industries, professions, and other fields of endeavor. "Passive" income received by an association is reinvested in tax-exempt activities of benefit to the public, rather than in recreational/social activities for a limited number of people. Applying the tax rules for social clubs to associations imposes unreasonable and unwarranted penalties on those organizations. For example, under the Administration's proposal, these organizations would be taxed on all investment income unless it is set aside for charitable purposes. Income that is used to further other legitimate organizational activities of value to the industry, the profession, and the public would therefore be taxed. In addition, the proposal would tax these organizations on all gains received from the sale of property unless those gains are reinvested in replacement property. This tax on gains would apply to real estate, equipment, and other tangible property. It would also apply, however, to such vastly diverse assets as software, educational material developed to assist an industry or profession, certification and professional standards manuals, and other forms of intellectual property which further exempt purposes.

It is important to note that the Administration's proposal targets only Section 501(c)(6) organizations. No other categories of tax-exempt organizations would be taxed in this proposal. The Administration's proposal inappropriately seeks to impose the tax scheme designed for Section 501(c)(7) social and recreational clubs only on Section 501(c)(6) associations. Congress has recognized that organizations exempt in these different categories serve different purposes and long ago fashioned a tax exemption scheme to reflect these differences. The Administration's proposal runs counter to common sense and would discourage or prevent Section 501(c)(6) organizations from providing services, including public services, consistent with the purposes for which these associations were granted exemption.

III. Taxation of Association Lobbying Activities.

The Clinton Administration's proposal has been characterized by the Secretary of the Treasury as a tax on "lobbying organizations," suggesting that associations somehow now enjoy a favored tax status for their lobbying activities. This is incorrect. Many associations do not conduct any lobbying activity. Moreover, the lobbying activities of associations have no tax preferences, advantages, or subsidies whatsoever; the funds are fully taxed by virtue of the Omnibus Budget Reconciliation Act of 1993. That law imposed a tax on all lobbying activities of trade and professional associations, either in the form of a flat 35% tax on all funds that the organization spends on lobbying activities, or as a pass-through of non-deductibility to individual association members.

Indeed, not only is there no tax benefit or tax exemption for associations' lobbying activities, either for the members or for the entities themselves, but the 1993 law provides a tax *penalty* on any funds used to lobby. Lobbying tax penalties can arise in essentially three ways:

1. *Proxy Tax.* The "proxy" tax, an alternative to informing association members of dues non-deductibility because of association lobbying, is set at a flat 35% level. This is the highest level of federal income tax for corporations, paid only by corporations with net incomes over $18.33 million. Associations are denied the "progressivity" of the income tax schedule. Therefore, even though no associations ever achieve nearly that level of income, they must pay the proxy tax as if they did.

2. *Allocation Rule.* Under the "allocation rule," all lobbying expenses are allocated to dues income to determine the percentage of members' dues that are non-deductible. Most associations pay for their lobbying expenses using many sources of income. Increasingly, associations have far more non-dues income than dues income. The allocation rule, however, requires association members to pay tax on all association income used to conduct lobbying activities, regardless of the percentage of lobbying actually paid for from their dues. Indeed, under the "allocation rule," a business can pay more tax if it joins an association that lobbies for a particular government policy than if the business had undertaken the lobbying itself.

3. *Estimation Rule.* The "estimation rule" requires that associations estimate in advance how much dues income and lobbying expense they anticipate. The estimation forms the basis for the notice of dues non-deductibility, which must be given at the time of dues billing or collection. If reality turns out to be different from the estimates, the association or its members are subject to very high penalties. There is no way to ensure freedom from the penalty for underestimating short of ceasing to spend money on lobbying the moment the association reaches its estimate. There is no way to avoid the penalty for overestimating at all.

Associations are therefore already subject to more than tax neutrality and absence of exemption or subsidy for lobbying activities. The Administration's proposal would not make any provision with respect to lobbying activities of these associations, although it would certainly generally weaken the financial resources of associations and reduce their ability to assist industries, professions, and the public. Indeed, the Administration's characterization of the proposal as one that addresses "lobbying organizations" is tantamount to an Administration decision to further weaken and suppress the ability of tax-exempt organizations to lobby at all.

IV. Taxation of Member Dues.

The Administration's proposal has also been justified by its proponents as eliminating a double tax advantage claimed to be enjoyed by dues-paying association members. According to the Administration, association members already receive an immediate deduction for dues or similar payments to Section 501(c)(6) organizations. At the same time, members avoid paying taxes on investment income by having the association invest dues surplus for them tax-free.

This argument is flawed for a variety of reasons:

- The argument implies that members voluntarily pay higher dues than necessary as an investment strategy. While in some circumstances members of tax-exempt associations can deduct their membership dues like any other business expense, members receive no other tax break for dues payments. As discussed above, they are in fact denied a deduction for any amount of dues their association allocates to lobbying expenses.
- The argument implies that associations overcharge their members for dues, thereby creating a significant surplus of dues income. In fact, dues payments usually represent only a portion of an association's income; and dues are virtually always determined by a board or committee consisting of members, who would hardly tolerate excessively high dues. Finally, associations tend to maintain only modest surpluses to protect against financial crises, expending the rest on programs and services. Again, associations are member-governed; members would typically make certain that their associations do not accumulate a surplus beyond the minimum that is necessary and prudent for the management of their associations.
- The argument assumes that Section 501(c)(6) organizations somehow pay dividends to their members. Tax-exempt organizations do not pay dividends or returns in any form to their members, let alone for payment of dues. Indeed, an organization's exempt status may be revoked if any portion of its earnings are directed to individuals.

In other words, the Administration suggests that association members are voluntarily paying higher than necessary dues, solely to avoid paying tax on their own investment income resulting when not all dues revenues are expended immediately. This is the same as suggesting that individuals donate to charities in hopes that the charities will earn investment income on un-spent donations. It is an argument that defies common sense and completely misunderstands the structure and operation of tax-exempt organizations.

V. EXPENDITURES ATTRIBUTED TO INVESTMENT AND OTHER "PASSIVE" INCOME WOULD GENERALLY QUALIFY AS DEDUCTIBLE EXPENSES IF INCURRED BY MEMBERS OF THE ASSOCIATION.

The investment income and other "passive" income of associations is used to further the exempt purpose of the organizations. Most if not all of these expenditures for association programs and activities, which are made on behalf of the association's members, would be deductible if carried on directly by the members. This is because these expenses would otherwise be regarded as ordinary and necessary business expenses under Section 162(a) of the tax code or as a charitable contribution. Therefore, it is inappropriate to essentially deny this deduction by imposing the UBIT tax on this income. Under the Administration's proposal, this would in fact be the indirect result of subjecting the "passive" income of Section 501(c)(6) organizations to taxation.

VI. THE ADMINISTRATION'S PROPOSED TAX WOULD REACH ALL FORMS OF "PASSIVE" INCOME AND JEOPARDIZE TAX-EXEMPT PROGRAMS.

Trade associations, individual membership societies, and other similar voluntary membership organizations typically receive only a portion of their income from membership dues, fees, and similar charges. In many such organizations, particularly professional societies, there are natural limits or "glass ceilings" on the amounts of dues that can be charged to members. As a result, these Section 501(c)(6) tax-exempt organizations have increasingly sought additional sources of income to enable them to continue their often broad programs of exempt activities on behalf of businesses, professions, and the public. One of those additional sources has been "passive" income—rents, royalties, dividends, interest, and capital gains—that may be earned from a variety of sources.

Section 501(c)(6) organizations rely heavily on "passive" income to support their exempt activities. The proposal would adversely affect virtually all associations, since most organizations from time to time receive some amount of rents, royalties, interest, dividends, or capital gains. These associations use "passive" income to further a host of beneficial activities which would be threatened by imposition of the Clinton Administration's "investment" tax. For example, Section 501(c)(6) tax-exempt associations are responsible for:

- Drafting and disseminating educational materials.
- Establishing skills development seminars and programs.
- Creating training and safety manuals for various professions.
- Producing books, magazines, newsletters, and other publications.
- Increasing public awareness, knowledge, and confidence in an industry's or a profession's practices.
- Conducting and sponsoring industry research and surveys.
- Compiling statistical data for industries and professions which is often requested or relied upon by government.
- Providing professionals and businesses with new technical and scientific information.
- Developing and enforcing professional safety and health standards.
- Developing and enforcing ethical standards for industry practice.
- Operating accreditation, certification, and other credentialing programs.
- Organizing and implementing volunteer programs.

The Administration's proposal imposes a broad-based, pervasive, and detrimental penalty on virtually all associations of any kind or size. A tax on the "investment income" of Section 501(c)(6) organization does not address any issue of income used for lobbying activities; all such activities by these organizations is already free of tax exemption or subsidy of any kind (indeed, it can be subject to offsetting "penalty" taxation). There is no double or special tax benefit to those who pay dues to associations. Instead the Administration's proposal taxes significant sources of funding that associations use now for highly desirable services to entire industries, professions, and the public. Treating Section 501(c)(6) organization in the same manner as social clubs ignores the special, quasi-public purposes and functions of associations, and threatens the ability of such organizations to continue to provide publicly beneficial services in the future. In summary, this proposal is a legitimate threat, albeit ill-conceived, to the ongoing viability of thousands of America's membership organizations, and should be rejected by this Committee.

Thank you for this opportunity to testify before you today. I would be happy to supplement this testimony with answers to any questions you may have.

Chairman ARCHER. Without objection, so ordered. The chair appreciates the testimony of all four of you. Specifically, I would like to ask Mr. Lifson and Mr. Tucker, who I think represent some of the finest talent, experience, and expertise in dealing with the Tax Code. I understand that you both are concerned about the complexity of the tax-relief proposals. However, I don't want to get into any of those issues for this question. Relative to the President's budget, which, if any, of the administration's revenue-raising proposals could you support and feel was justified by tax policy?

Mr. TUCKER. We clearly can support the focus on corporate tax shelters. We think——

Chairman ARCHER. That is mentioned in your testimony, correct?

Mr. TUCKER. Right. Sixteen provisions are too many. They are too complex. We think there needs to be a straight focus on disclosure, but we can support the focus on that as long as it does not eliminate legitimate business transactions for which there is a business purpose.

Chairman ARCHER. Have you been able to examine in detail the administration's proposal on tax shelters?

Mr. TUCKER. We have, and we are doing it. We have set up a task force to work specifically with the——

Chairman ARCHER. But you have not reached a conclusion about the details of that proposal?

Mr. TUCKER. No, sir.

Chairman ARCHER. All right. Well, we will be happy to have your input when you do reach that conclusion.

Mr. TUCKER. We will be glad to.

Chairman ARCHER. Which, if any, other revenue-raiser in the President's budget would either one of you support?

Mr. LIFSON. The only area that we feel extreme concern about is the treatment of tax-indifferent parties, which I think is part of the 16 specific areas, or the tax-shelter area. We have no position yet on any of the other revenue-raisers. We are working on a supplemental submission at this time.

Chairman ARCHER. So you are not in a position to either support or oppose all of the other revenue-raisers?

Mr. LIFSON. Correct.

Chairman ARCHER. How soon do you think you might conclude your analysis?

Mr. TUCKER. We can get back to you within a couple of weeks. We have no problem going through that in detail.

Chairman ARCHER. Fine. That would be very helpful. Thank you. Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman. Let's see, Mr. Sinclaire, I believe that in your written testimony you outlined nine different forms of tax cuts that you favor for business. What would be the cost of those to the Treasury.

Mr. SINCLAIRE. I do not have a revenue estimate on those items.

Mr. DOGGETT. You do not have a——

Mr. SINCLAIRE. No, I do not.

Mr. DOGGETT. Is it something you could supply the Committee?

Mr. SINCLAIRE. We do not have any basis to develop revenue estimates. We would rely on revenue estimates that come from the Joint Committee.

Mr. DOGGETT. And in addition to those nine specific forms, did I understand your oral testimony to be that you favor repealing all taxes on corporate profits?

Mr. SINCLAIRE. No.

Mr. DOGGETT. You do not? Your focus is on these nine specific forms?

Mr. SINCLAIRE. That is not the complete list. There are other items where we support tax reform such as extension of section 127, items of that nature, the WOTC, the welfare-to-work tax credit. Also, there are other items. This is not an exclusive list of items.

Mr. DOGGETT. One gets the impression from the Forbes article that I referenced earlier and from other sources, that some corporate officials are actually being harassed into using these tax shelters by what are referred to as tax-shelter hustlers. Do you find that to be a problem?

Mr. SINCLAIRE. The Chamber does not provide tax advice——

Mr. DOGGETT. The Chamber took a position on these nine forms of tax cuts. Do you think that it is important to address this problem of tax hustlers and the whole problem of tax shelters and tax avoidance?

Mr. SINCLAIRE. When there is an abusive situation, the Chamber does not condone that. So in that sense, yes we would favor that there be some examination and possible changes.

Mr. DOGGETT. Mr. Tucker, with reference to your testimony, is this problem of aggressive positions by tax shelter hustlers a sizable one in this country?

Mr. TUCKER. Whenever you have significant tax reduction that occurs, not because of business purpose or business-related, but simply because somebody is marketing a product that combines different provisions of the Code that were not intended to be utilized together, we think that does create problems. When you see the corporate taxes are reduced at the cost of what could otherwise be benefits for individuals or small business, then we think, yes, that is still a problem.

Mr. DOGGETT. And I would suppose that it is also a professional problem, reflecting on those tax practitioners who are trying to counsel their clients to comply completely with the tax law if there is somebody down the street suggesting you can avoid a significant amount of tax?

Mr. TUCKER. Yes, sir.

Mr. DOGGETT. If I understand one of your specific recommendations, in which I think you do share with the Treasury that is mentioned in your testimony, you believe that it is important that there be penalties not only against the corporations that might have taken advantage of one of these improper rackets, but more particularly to focus it on the people that hustled them into it and sold them on one of these improper schemes.

Mr. TUCKER. Yes, sir, as well as the tax-indifferent party that may be joining into that scheme.

Mr. DOGGETT. And you offer that on behalf of your section even though, I suppose, there may be some, certainly some tax lawyers in the country, and maybe some members of your section, that could be subject to these penalties.

Mr. TUCKER. We believe that this is a very important set of provisions for the country as a whole. We recognize that any time something is done prospectively, you may eliminate certain very beneficial items to certain people, but we think this is something that is important for the country.

Mr. DOGGETT. You mentioned prospectively. Is it important that there be a capacity to apply some of these penalties retroactively?

Mr. TUCKER. We think that we already have a number of provisions in the Code, that, if we had the funding for the Revenue Service to go out and do the proper scrutiny analysis (when you have substance versus form, when you have the step transaction theory), the business purpose theory—there are already a number of points that could be utilized.

What we are really looking at is the ability to have them look at items because disclosure has been given, and we think that is important, because even those activities that have happened in the past could be picked up under these preexisting judicial and legislative actions.

Mr. DOGGETT. The Forbes article suggested that just one firm here in the Washington, DC, area had as many as 40 people out promoting these kinds of schemes. Just in terms of the dimension of the problem around the country, are there a significant number of people involved in promoting questionable tax schemes around the country?

Mr. TUCKER. Legend says that there are. I cannot tell you whether there are, but we hear that there are numbers of people, but I certainly could not say who they are or what numbers there are.

Mr. DOGGETT. Thank you. Look forward to getting your report.

Mr. TUCKER. Thank you, sir.

Mr. HOUGHTON [presiding]. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. Appreciate the panel's testimony here and recognize we have a vote and we are going to have to break for a few minutes to go vote. I will try and be quick.

First, Mr. Lifson, your testimony on simplifying the Code, I welcome that, and your suggestions and ideas. And not only do you note that once again the administration in their targeted tax cuts create more marriage-tax penalties with their phase-outs. Right now, I think, in addition to the joint filers, the marriage tax penalty, and then if you add in over 60 additional marriage penalties that are created by various phase-outs, we really don't need three or four more, which the administration proposes adding to complicate the Tax Code even more.

And I would also like to mention in your testimony on page 4 that some suggestions that you propose as we look for ways to simplify the Tax Code and, of course address some of the unfairness, you suggest marriage-tax penalty relief, increasing the amount for personal exemptions, increasing the standard deduction, and also expanding the 15-percent tax bracket. And I just want you to urge you to take a look at a tax simplification package that Rep. Dunn and I have offered, which we believe simplifies the Code as well as addresses the unfairness in the Tax Code.

And one of the things we do is we expand the 15-percent bracket. So a family of four making $55,000 is in the 15-percent tax bracket, rather than the 28-percent tax bracket as they are today. Eliminate the marriage penalty, eliminate the death tax, eliminate tax on retirement savings. And so I welcome your suggestions and I am anxious to look at this further.

I recognize because of the vote we are going to have to run here. But I do want to ask a quick question of Mr. Olson.

Mr. OLSON. Yes, sir.

Mr. WELLER. The administration is part of the $176 billion tax increase package that the President proposes in his budget, includes a new tax on associations, which you referenced in your testimony. A lot of times when people think of associations they think of Chamber of Commerce, they think of the Farm Bureau, they think of the National Federation of Independent Business. Can you give an example of some of the smaller groups that—and give an example not only of a smaller organization, but also the impact of this new tax increase that the administration wants to impose on the money they have in the bank account, for example, with the tax on the interest they would have in the money they would set aside from dues and that. Could you give an example?

Mr. OLSON. I might answer your question in reverse order. The issue of accruing investments and creating a fund balance for a nonprofit or tax-exempt organization is important to understand because it is the result of careful stewardship over many, many years, and in many instances, decades, of volunteer leadership, where you are in an environment corporately where nothing can inure to the benefit of one individual. You have group stewardship of these resources. So these are not fast, overnight, quick-buck profits that have been accumulated by a corporation, these are carefully shepherded investment funds that have grown through prudent management of member resources over many years.

Examples of some of the smaller groups that have fund balances that could be impacted extend to groups like Rotary clubs, Boy Scouts, Young Republicans, the Democratic Women, of State organizations, local organizations. Anything with a (c)(6) in its classification under the Internal Revenue Service code, and there are over 70,000 such organizations, would be directly impacted by this.

And the average of these 70-some thousand in terms of the investment revenues as a part of their total budget runs about 5.5 percent. Regardless of the size budget, the percentage is about the same. And that is a big part of their operation.

Mr. WELLER. Mr. Olson, you indicated, you have just made the statement that the Young Republicans, the Democratic Women's Club—I guess I'm running out of time because of this—you know, one point I would like to make is that, you know, Secretary Lubick said somehow the individual members will benefit by the new tax on their organization. And I hope that you can submit some testimony for the record——

Mr. OLSON. We have for the record. It's in our lengthy preparation. Yes, sir, it is there in detail.

Mr. WELLER. Thank you.

Mr. OLSON. Thank you for asking.

Mr. HOUGHTON. Gentlemen, I am sorry. We have to vote. We will have to leave. And then as soon as we have our vote, maybe votes, we will take a look at our next panel, Mr. Kies, Weinberger, Wamberg, and Hernandez. Thank you very much for coming. Sorry we have to push it.

[Recess.]

Chairman ARCHER [presiding.] The Committee will come to order. Our next panel, which is our second-to-last panel, is before us now, and welcome. Mr. Kies, if you will identify yourself—I know you are relatively unknown [laughter] in this room—you may proceed.

STATEMENT OF KENNETH J. KIES, MANAGING PARTNER, WASHINGTON NATIONAL TAX SERVICES, PRICEWATERHOUSECOOPERS LLP

Mr. KIES. Thank you, Mr. Chairman. My name is Ken Kies. I am a managing partner at PricewaterhouseCoopers, Washington National Tax Services office. The firm has more than 6,500 tax professionals in the United States and Canada, and works closely with thousands of corporate clients worldwide, including most of the Fortune 500.

I'm here to comment on the administration's corporate tax shelter proposals, specifically the first six proposals in the Treasury's list under that section. My comments summarize the key points of a 50-page analysis we have prepared on these proposals and which has been made available to the Committee today.

Our analysis reflects the collective experience of many of the firm's corporate clients. In our view, these proposals are overreaching, unnecessary, and at odds with sound tax-policy principles. In my brief time today, I am going to give you several reasons why these proposals should be rejected.

First, despite statements made by the administration and inferences left by the recent Forbes article on tax shelters, there is no revenue data or other evidence that would suggest that corporate tax planning is eroding the corporate income tax base. To the contrary, as CBO data show, corporate income tax payments as a percentage of GDP over the past 4 years are at their highest level since 1980, and are projected to remain there for the next 10 years.

Second, Treasury and IRS already have more than adequate tools to address perceived abuses. These include numerous tax penalties, common-law doctrines, like the economic substance and business purpose doctrine, and more than 70 antiabuse provisions in the Code today. Treasury also has the ability to move quickly to respond to perceived abuses by issuing administrative notices.

Third, Treasury and IRS have not used the tools they already have. Congress in 1997 enacted legislation broadening the definition of a tax shelter, subject to stiff penalties. At that time, Commerce expressly stated that this change would discourage taxpayers from entering into questionable transactions.

As of today, Treasury, still has not issued regulations necessary to activate the 1997 changes. Without having used the tools that Congress specifically granted in 1997, the administration is now asking for a new set of tools it believes are more appropriate.

Fourth, the proposals presented by Treasury are dangerously vague. They turn on a subjective and, I believe, unadministerable definition of a tax-avoidance transaction. This definition could be used by the IRS agents to increase taxes on a broad range of legitimate business transactions.

The IRS would have the authority simply to deny tax benefits even for transactions that clearly comply with substantive tax law.

I believe these proposals, if enacted, would represent the broadest grant of discretion ever given by a Congress to agents of the IRS. Ironically, this would come a year after Congress took action to rein in the power of IRS agents.

Fifth, corporate tax executives have told us that these proposals would make their jobs nearly impossible. There could be no certainty as to the tax treatment of complex business transactions, which are often undertaken across borders and are subject to a patchwork of laws imposed by U.S., foreign, State, and local taxing jurisdictions. And let's not forget that these corporate tax executives are the individuals who are in charge of collecting more than one-half of the total tax revenue that fund our government, not only through corporate income tax payments, but also through individual income tax and payroll tax withholding and the collection of the bulk of the existing excise taxes.

Sixth, corporate tax executives are conservative by nature. In addition to being bound by professional and company-imposed ethical standards, they have a fiduciary duty to avoid monetary penalties that could reduce their company's profitability. Moreover, most corporations are extremely sensitive about preserving and enhancing their corporate image, thus corporate tax executives are careful not to recommend a transaction to their management that later might be reported unfavorably in the national press.

Because of the extreme complexity of tax rules, corporate tax executives need assistance from their professional advisers and other to help determine tax-efficient and prudent ways to implement business objectives.

Seventh, I believe these proposals would represent a dramatic shift in the balance between the Congress and executive branch in terms of tax policymaking. For many years, Congress and the executive branch have had differing views on the merits of proposed changes to tax law. As an example, the current administration in its past three submissions on the budget, has advanced more than 40 revenue-raising proposals that have been opposed by the Congress, in many cases on a bipartisan basis. This is a healthy tension, one that more often than not yields correct tax policy decisions. The administration's proposals effectively would ask Congress to allow the executive branch in the form of the individual IRS agent to dictate much of tax policymaking.

To conclude, Treasury and the IRS already have more than ample tools to address situations involving abusive tax planning. Some tools that you have provided have gathered dust for 2 years. At this time, I believe there is no demonstrated need to expand on these tools, particularly in such a way that would give IRS agents nearly limitless authority to recast the tax treatment of legitimate business transactions.

I would be happy to answer any questions that you or the Members of the Committee have, Mr. Chairman. Thank you.

[The prepared statement and attachments follow. Appendices to the statement are being retained in the Committee files.]

Statement of Kenneth J. Kies, Managing Partner, Washington National Tax Services, PricewaterhouseCoopers LLP

I. *Introduction*

PricewaterhouseCoopers appreciates the opportunity to submit this written testimony to the Committee on Ways and Means on the revenue-raising proposals included in the Administration's FY 2000 budget submission.

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

Our testimony focuses on broad new measures proposed by the Administration relating to "corporate tax shelters." Specifically, these include proposals that would (1) modify the substantial understatement penalty for corporate tax shelters; (2) deny certain tax benefits to persons avoiding income tax as a result of "tax-avoidance transactions"; (3) deny deductions for certain tax advice and impose an excise tax on certain fees received with respect to "tax-avoidance transactions" (4) impose an excise tax on certain rescission provisions and provisions guaranteeing tax benefits; (5) preclude taxpayers from taking tax positions inconsistent with the form of their transactions; and (6) tax income from corporate tax shelters involving "tax-indifferent parties."[1]

In our view, these proposals are overreaching, unnecessary, and at odds with sound tax policy principles. They introduce a broad and amorphous definition of a "corporate tax shelter" that could be used by Internal Revenue Service (Service) revenue agents to challenge many legitimate transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. If enacted by Congress, these proposals would represent one of the broadest grants of authority ever given to the Treasury Department in the promulgation of regulations and, even more troubling, to Service agents in their audits of corporate taxpayers.

A. INITIAL OBSERVATIONS.

1. Revenue data shows no erosion of the corporate tax base.

Before turning to our specific concerns with the Administration's proposals, it is worthwhile to consider several important points. First, these proposals have arisen in response to a perception at the Treasury Department that tax-planning activities are eroding the corporate tax base.[2] The facts suggest otherwise. Corporate income tax payments reached $189 billion in 1998 and are projected by the Congressional Budget Office (CBO) to grow to $267 billion in the next 10 years.[3] Projections by the CBO and the Office of Management and Budget (OMB) show that these corporate revenues will remain relatively stable as a share of the overall economy in the coming years. There is no data in the projections of CBO or OMB to suggest that corporate tax activity will cause corporate tax revenues to decline in the future.

Moreover, corporate income tax receipts as a percentage of taxable corporate profits stood at 32.4 percent in 1998 and are projected to remain relatively constant over the next 10 years (32.5 percent in 2008).[4] This is approximately the effective tax rate that would result by subjecting all corporate taxable income to the graduated corporate tax rate schedule, which taxes income at rates starting at 15 percent and

[1] *General Explanation of the Administration's Revenue Proposals*, Department of the Treasury, February 1999, pp. 95–105.

[2] *Budget of the United States Government: Fiscal Year 2000, Analytical Perspectives*, p. 71.

[3] *The Economic and Budget Outlook: Fiscal Years 2000–2009*, Congressional Budget Office, January 1999, p. 53.

[4] *Ibid.*

increasing to the top statutory rate of 35 percent.[5] The CBO measure of the corporate tax base is based, with minor modifications, on the economic profits measured by the national income and product accounts rather than income reported for tax purposes. As a result, there is nothing in this forecast to suggest that the corporate tax base is under assault from an imagined new "market" in corporate tax shelters.

In fact, during the past four years corporate income tax payments as a percentage of gross domestic product have reached their highest levels since 1980.[6]

2. The proposals are inconsistent with the Congressional view that the scope of Treasury Department authority should be limited.

The Administration's proposals run counter to the spirit of recent Congressional actions. In last year's landmark Internal Revenue Service Restructuring and Reform Act,[7] Congress enacted significant new limitations on the authority of Service agents in audit situations. Now, a mere eight months later, the Administration is asking Congress to empower agents with broad authority to "deny tax benefits" where they see fit.

In last year's Administration budget (for FY 1999), Treasury asked for expansive authority to "set forth the appropriate tax results" and "deny tax benefits" in hybrid transactions[8] and in situations involving foreign losses.[9] Congress dismissed these proposals. The FY 2000 budget proposals now ask for authority of the same type but significantly broader than the authorization that Congress rejected just last year. The Treasury's new proposals thus can be seen as an attempted end run around earlier failed initiatives—this time accompanied by the shibboleth of "stopping tax shelters."

3. Congress in the past has taken actions to stop perceived tax shelter abuses when necessary.

Congress has been alert to perceived tax shelter issues and has taken a series of actions in the past. In fact, Congress in 1997 enacted legislation[10] broadening the definition of a "tax shelter" subject to stiff penalties under the Internal Revenue Code and requiring that such arrangements be reported in writing to the Service.[11] The Joint Committee on Taxation's "Blue Book" explanation discusses the intent underlying these changes:[12]

> The Congress concluded that the provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.

Nineteen months later, the Treasury Department has yet to implement the new tax shelter reporting rules. To provide fair notice to taxpayers, Congress made the effective date of these provisions contingent upon Treasury's issuing guidance on the new requirements. But as of this date, no such guidance has been issued. It is totally inappropriate from the standpoint of sound tax policy that Treasury at this time would request expanded authority to address the issue of tax shelters when it has eschewed recent authority explicitly granted by the Congress on the identical issue.[13]

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[5] Approximately 80 percent of corporate income is earned by corporations subject to the 35-percent top statutory rate. The largest 7,500 corporations account for approximately 80 percent of all the corporate income tax collected.

[6] *The Economic and Budget Outlook: Fiscal Years 2000–2009*, *supra* n.4., at 131.

[7] Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105–208.

[8] *General Explanation of the Administration's Revenue Proposals*, Department of the Treasury, February 1998, p. 144.

[9] *Id*. at 143.

[10] Taxpayer Relief Act of 1997, P.L. 105–34.

[11] Under the 1997 legislation, the statutory definition of a tax shelter was modified to eliminate the requirement that the tax shelter have as "the principal purpose" the avoidance or evasion of Federal income tax; the new law requires only that the tax shelter have as "a significant purpose" the avoidance or evasion of tax. See discussion in Part IV below of current penalties and registration requirements applicable to tax shelters.

[12] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS–23–97), December 17, 1997, p. 222.

[13] It should be noted that this unfinished regulation project is but one of many interpretive projects that the Treasury Department has not completed; the collective effect of this unfinished work is considerable uncertainty for corporate taxpayers attempting to comply with the tax law in good faith. This issue will be discussed further in these comments, and an illustrative list of unfinished regulation projects relevant to corporate taxpayers is set forth in Appendix F.

Moreover, the Administration's penalty proposals come at the same time that Treasury and the Joint Committee on Taxation, as required by the 1998 Internal Revenue Service Restructuring and Reform Act, are conducting studies reviewing whether the existing penalty provisions are "effective deterrents to undesired behavior."[14] These studies, which are required to be completed by this summer, are to make any legislative and administrative recommendations deemed appropriate. The Treasury proposals, if enacted, would preempt the careful penalty review process that was designed by the Congress last year.

Meanwhile, Congress and Treasury successfully have worked together to identify specific situations where the tax laws are being applied inappropriately and to enact quickly substantive tax-law changes in response. Recent examples include legislation enacted or introduced relating to liquidations of REITs or RICs[15] and transfers of assets subject to liabilities under section 357(c).[16] The Administration's FY 2000 budget proposes a series of specific changes in a number of other areas. Whether or not the tax policy rationales given by Treasury for these targeted proposals are persuasive, the appropriate manner in which to curb avoidance potential is for Congress to deliberate upon specific legislative proposals, and not to grant broad and unfettered authority to Treasury and Service revenue agents.

Finally, it should be mentioned that the broad grant of authority in the Treasury Department tax shelter proposals is totally unnecessary. On several occasions in recent years, Treasury has determined that administrative actions were necessary to stop certain perceived avoidance transactions.[17] While we may not agree that Treasury's action was appropriate in each instance that such action was taken, it is clear that no further grant of authority is necessary or warranted from the Congress on these matters.

B. Outline of comments.

These comments set forth a number of key considerations that should be weighed by Congress in evaluating the Administration's corporate tax shelter proposals:

- First, we discuss each of the Administration's corporate tax shelter proposals, offering a brief critique and analysis on tax policy grounds.
- Second, we explore the potential detrimental impact of the Administration's proposals on an illustrative series of legitimate business transactions.
- Third, we analyze the existing tools that are available to the Treasury Department and the Internal Revenue Service—and Congress—to address tax shelters and other perceived abuses under the tax system. This discussion includes an explanation of current-law penalty and disclosure rules; specific anti-abuse rules; common-law doctrines (e.g., "economic substance" and "substance over form") that may be invoked; and opportunities to address abuses through legislative action.
- Fourth, we discuss the vital role played by corporations in administering U.S. tax laws—while dealing with their complexity—and the important responsibilities of corporate tax directors to their shareholders. These roles and responsibilities are often overlooked during consideration of U.S. corporate income tax policy.
- Finally, we discuss the role played by accounting firms in advising corporations on tax issues.

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[14] P.L. 105–208, sec. 3801.

[15] P.L 105–277, sec. 3001 (provision aimed at attempts to read statutory provisions as permitting income deducted by a liquidating REIT or RIC and paid to its parent corporation to be entirely tax free during the period of liquidation).

[16] A provision addressing the tax treatment of certain transfers of assets subject to liabilities described in section 357(c) passed the House February 8, 1999, as part of H.R. 435; an identical provision was approved by the Senate Finance Committee January 22, 1999, as part of S. 262. The provisions would apply to transfers on or after October 19, 1998, the date on which House Ways and Means Committee Chairman Bill Archer introduced legislation on this topic. That legislation was developed by Chairman Archer in coordination with the Treasury Department in response to concerns that some taxpayers were structuring transactions "to take advantage of the uncertainty" under the tax law.

[17] Treasury Department activities to stop perceived avoidance transactions will be discussed in further detail in these comments. An illustrative list of prior Treasury Department administrative actions to stop perceived avoidance is set forth in Appendix C.

II. ANALYSIS OF ADMINISTRATION S CORPORATE TAX SHELTER PROPOSALS

A. MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR CORPORATE TAX SHELTERS.

1. Treasury proposal.

The proposal generally would increase the penalty applicable to a substantial understatement by a corporate taxpayer from 20 percent to 40 percent for any item attributable to a "corporate tax shelter," effective for transactions occurring on or after the date of first committee action. In addition, the present-law reasonable cause exception from the penalty would be repealed for any item attributable to a corporate tax shelter.

A "corporate tax shelter" would be defined as any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A "tax benefit" would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit "clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code)."

A "tax avoidance transaction" would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present-value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present-value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

2. Analysis.

This proposal is overbroad, unnecessary, and totally inconsistent with the goals of rationalizing penalty administration and reducing taxpayer burdens.

First, the proposal creates the entirely new and vague concept of a "tax avoidance transaction." The first prong of the definition of a tax avoidance transaction is styled as an objective test requiring a determination of whether the present value of the reasonably expected pre-tax profit from the transaction is insignificant relative to the present value of the reasonably expected tax benefits from the transaction. However, the inclusion of so many subjective concepts in this equation precludes its being an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test? Next, what are the parameters for "reasonable expectation" in terms of both pre-tax economic profit and tax benefits? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits?

Not only is this prong of the test extremely vague, the uncertainty is compounded by the second prong of the definition of tax avoidance transaction. Under this alternative formulation, certain transactions involving the improper elimination or significant reduction of tax on economic income would be considered to be tax avoidance transactions even if they did not satisfy the profit/tax benefit test described above. The inclusion of this second prong renders the definition entirely subjective, with virtually no limit on the Service's discretion to deem a transaction to be a tax avoidance transaction.

Second, elimination of the reasonable cause exception would result in situations where a revenue agent is compelled to impose a 40-percent penalty even though the agent determines that (1) there is substantial authority supporting the return position taken by the taxpayer, and (2) the taxpayer reasonably believed (based, for example, on the opinion or advice of a qualified tax professional) that its tax treatment of the item was more likely than not the proper treatment. If, in that situation, a revenue agent concluded it would be appropriate to "waive" the penalty, the agent could do so only by determining that the transaction in question was not a corporate tax shelter, i.e., that the increased penalty was not applicable. Over time, one clearly unintended consequence of forcing revenue agents to make such choices might be a skewed definition of the term "tax shelter."

The automatic nature of the proposed increased penalty would alter substantially the dynamics of the current process by which the vast majority of disputes between the Service and corporate taxpayers are resolved administratively. Today, even where a corporation and the Service agree that there is a substantial understatement of tax attributable to a tax shelter item, the determination as to whether the substantial understatement penalty should be waived for reasonable cause continues to focus on the merits of the transaction and the reasonableness of the taxpayer's beliefs regarding those merits. If, however, the reasonable cause exception no longer were available, the parties necessarily would have to focus on whether the transaction in question was a "tax avoidance transaction" and other definitional issues unrelated to the underlying merits of the transaction.

Stripping revenue agents of their discretion to waive penalties for reasonable cause would make it more difficult for the Service to achieve its objective of resolving cases at the lowest possible level. Unnecessary litigation also would result. In many cases, the size of the penalty and the absence of flexibility regarding its application could compel the taxpayer to refuse to concede or compromise its position on the merits of the issue, since only by prevailing on the merits could the taxpayer avoid the penalty. Moreover, the mere availability of such an onerous penalty may cause some revenue agents to threaten its assertion as a means of exacting unrelated (and perhaps unwarranted) concessions from the taxpayer. Clearly, the use of the increased substantial understatement penalty as a "bargaining chip" is not appropriate or warranted for the proper determination of tax liability of a corporation and the efficient administration of the examination process.

Increasing the penalty on substantial understatements that result from corporate tax shelters to 40 percent also would be inconsistent with the Service's published policy regarding penalties. Policy Statement P–1–18 states that "[p]enalties support the Service's mission only if penalties enhance voluntary compliance." Similarly, Internal Revenue Manual (20)122 provides that "[t]he fundamental reason for having penalties is to support and encourage voluntary compliance." Thus, the Service's principal purpose in asserting penalties is not to punish, but rather to ensure and enhance voluntary compliance. The imposition of a 40-percent substantial understatement penalty in situations where under current law reasonable cause would be found to exist would punish taxpayers that in fact are in compliance with the tax laws.

Creating new penalties—especially ones whose applicability depends on whether a particular transaction meets an inexact definition—would put too many revenue agents in a position of having to interpret statutes, rules, and regulations unrelated to the substance of the issue or transaction in question. Based on our experience, it is likely that many agents would find it easier and less risky to assert the new penalty rather than expose themselves to being second-guessed by others at the Service as to whether the penalty was applicable. Accordingly, pressures on revenue agents may cause the new penalty to be asserted initially in far too many circumstances than are warranted.

Further, the Service historically has had significant difficulty administering civil tax penalties fairly and consistently among regions, service centers, district offices, and functions. Those difficulties resulted in the Commissioner's establishing a task force in 1987 to study civil tax penalties, the issuance of a report by that task force in February 1989, a legislative overhaul of the Code's penalty provisions in 1989,[18] and the creation and issuance of the Consolidated Penalty Handbook as part of the Internal Revenue Manual.

It is evident that Congress believes there is room for significant further improvement and clarity in the administration of penalties. As discussed above, the Internal Revenue Service Restructuring and Reform Act of 1998 requires the Joint Committee on Taxation and the Treasury Department to conduct separate studies regarding whether the current civil tax penalties operate fairly, are effective deterrents to undesired behavior, and are designed in a manner that promotes efficient and effective administration.[19] The Joint Committee and Treasury will make whatever legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. With these important studies in process at this time, this legislative proposal to increase the substantial understatement is ill-conceived and unwarranted.

B. DENY CERTAIN TAX BENEFITS TO PERSONS AVOIDING INCOME TAX AS A RESULT OF TAX-AVOIDANCE TRANSACTIONS.

1. Treasury proposal.

The proposal would expand the current-law rules in section 269 to authorize Treasury to disallow a deduction, credit, exclusion, or other allowance obtained in a "tax avoidance transaction" (as defined above). The proposal would be effective for transactions entered into on or after the date of first committee action.

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[18] The "Improved Penalty Administration and Compliance Tax Act" was enacted as part of the Omnibus Budget Reconciliation Act of 1989. (P.L. 101–239, secs. 7701–7743)

[19] See n.14, *supra.*

2. Analysis.

In crafting this proposal, Treasury has disregarded the off-quoted observation of Judge Learned Hand that taxpayers are entitled to arrange their business affairs so as to minimize taxation and are not required to choose the transaction that results in the greatest amount of tax.[20] Under the Treasury proposal, even though a taxpayer's transaction has economic substance and legitimate business purpose, the Service would be empowered to deny the tax savings to the taxpayer if another route of achieving the same end result would have resulted in the remittance of more tax.

Essentially, this proposal would grant unfettered authority to the Service to determine independently whether a taxpayer is engaging in a transaction defined as a "tax avoidance transaction," and, based on that determination, to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer. A tax avoidance transaction would be defined to include a transaction involving the "improper elimination" or "significant reduction" of tax on economic income. In other words, if the Service believed for any reason that the taxpayer had structured a transaction that yields too much in tax savings, it would have the power to strike it down. This power could be invoked without regard to the legitimacy of the taxpayer's business purposes for entering into the transaction or the economic substance underlying the transaction. In other words, if the transaction is too tax efficient, then it simply would not be permitted by the Service.

The Administration states that this proposed enormous expansion of the current section 269 rules must be adopted because the current-law restrictions only apply to the acquisition of control or the acquisition of carryover basis property in a corporate transaction. It is important to place the current rules in context. The statutory rule has been in the tax law since 1943. Congress at that time was concerned that corporations were trafficking in net operating losses and excess profits credits.[21] The statute is focused on acquisitions of corporate control and nontaxable corporate reorganizations that produce tax advantages following the combination that were not independently available to the parties prior to the combination.

The original objective for enactment of section 269—to police the transfer of tax benefits in corporate combinations—has been virtually superseded by other statutes and regulations. For example, sections 382, 383, and 384 provide detailed limitations on the use of NOLs, built-in deductions, and tax credits following certain corporate combinations. The consolidated return regulations under section 1502 contain numerous limitations on the use of net operating losses, built-in deductions, and tax credits following the addition of a new member to a consolidated group. Further, section 1561 places limits on surtax exemptions in the case of certain controlled corporate groups.

Nevertheless, even though section 269 has been superseded in certain respects by subsequent specific legislation and thereby rarely is applied, taxpayers considering prudent planning transactions must take into account section 269 in many different corporate contexts because of the broad reach of its provisions. This statute results in burdensome and time-consuming administrative issues for taxpayers and revenue agents alike, with few changes in positions ultimately required and little revenue generated in return. The issue of whether the taxpayer has obtained a particular benefit it would not otherwise enjoy often is a difficult determination, and determining the taxpayer's principal purpose is a subjective exercise. This results in a lack of uniformity in the statute's application.

The Administration now proposes to expand significantly an outdated and significantly superseded statute. The proposal would cover transactions that significantly reduce tax on what the Service views as "economic income." Such potentially broad application would create uncertainty for corporate taxpayers following prudent tax planning to implement business objectives in a variety of transactions.

Another significant expansion of section 269 contemplated in the Treasury proposal is to cover any "exclusion" obtained in conjunction with any broadly defined "tax avoidance transaction." Currently, section 269 refers only to a "deduction, credit or other allowance" secured by the taxpayer in an inappropriate manner. Under current law, courts have refused to apply section 269 in instances where the secured benefit is an exclusion from income.[22] To address the allocation of income from one

[20] Judge Hand wrote: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions" (*Comm'r v. Newman*, 159 F.2d 848, 850–51 (2d Cir.1947) (dissenting opinion)).

[21] See H.Rpt. No. 871, 78th Cong., 1st Sess. 49 (1943).

[22] *Modern Home Fire and Casualty Insur. Co. v. Comm'r*, 54 TC 839 (1970).

taxpayer to another, Congress has legislated other provisions, such as the allocation rules of section 482 under which Treasury has promulgated comprehensive regulations. No tax policy rationale exists for the expansion of current section 269 to cover these situations.

C. DENIAL OF DEDUCTIONS FOR CERTAIN TAX ADVICE; EXCISE TAX ON CERTAIN FEES RECEIVED WITH RESPECT TO CORPORATE TAX SHELTERS.

1. Treasury proposal.

The Treasury proposal would deny a deduction to a corporation for fees paid or incurred in connection with the purchase and implementation of corporate tax shelters and the rendering of tax advice related to corporate tax shelters. The proposal also would impose a 25-percent excise tax on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to the underwriting or other fees) and the rendering of tax advice related to corporate tax shelters. These proposals would be effective for fees paid or incurred, and fees received, on or after the date of first committee action.

2. Analysis.

The imprecise definition of a corporate tax shelter transaction contained in this and related Treasury proposals would make it difficult for taxpayers and professional tax advisers to determine the circumstances under which this provision would be applicable. The substantive burdens of interpreting and complying with the statute and the administrative problems that taxpayers and the Service would face in attempting to apply this provision cannot be overstated.

Further aggravating the complexity and burdens that are imbedded in this proposal is the fact that the ultimate determination that a particular transaction was a corporate tax shelter may not be made until several years after the fees are paid. In that situation, issues arise as to when the excise tax is due, whether the applicable statute of limitations has expired, and whether and upon what date interest would be owed on the liability.

More fundamentally, the creation of the proposed excise tax subjects tax advisers to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction to unrelated definitional and computational issues. It is also unclear who would administer or enforce this new tax regime. For instance, if the existence of a tax shelter is determined as a result of an income tax examination of a corporation, would the revenue agents conducting that examination have jurisdiction over a resulting excise tax examination of the taxpayer's tax adviser? Would the income tax and excise tax examinations be conducted concurrently? How would conflicts of interest between the taxpayer and the adviser be identified and handled? These are only a few of the serious real-world issues that would have to be resolved to administer an inherently vague and cumbersome proposal.

Finally, the real possibility exists that the effect of the proposal may be to deter certain taxpayers from seeking and obtaining necessary advice and guidance from a qualified tax professional in many transactions where the broad and vague scope of the prohibition calls into question the ultimate deductibility of fees. In many such cases, it is likely that qualified tax advice would have either convinced the taxpayer that it would be unwise or improper to enter into the transaction, or resulted in the restructuring of the transaction so as to bring it within full compliance with the letter and spirit of the internal revenue laws.

D. IMPOSE EXCISE TAX ON CERTAIN RESCISSION PROVISIONS AND PROVISIONS GUARANTEEING TAX BENEFITS.

1. Treasury proposal.

The proposal would impose on the corporate purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment under a "tax benefit protection arrangement" (including a rescission clause and insurance purchased with respect to a transaction) at the time the arrangement is entered into. The proposal would apply to arrangements entered into on or after the date of first committee action.

2. Analysis.

This proposal breaches basic normative rules of tax law by purporting to tax an expectancy, and by not limiting tax to income received or realized by a taxpayer.

As a practical matter, the provision fails to consider the way rescission provisions or guarantees work. Generally, such an agreement puts the tax adviser at risk for an agreed-upon percentage of the amount of additional tax for which the taxpayer ultimately is liable as a result of the transactions to which the adviser's advice relates. That amount, of course, cannot be determined unless and until the Service proposes adjustments to the taxpayer's liability related to the item or transaction in question, and the taxpayer's correct liability is either agreed upon or determined by a court. Until such time, it is unclear how an excise tax determination appropriately could be made, and assessing tax based upon the highest potential rescission benefits obtainable by a taxpayer in the future, whether actually realized or not, contravenes basic issues of fairness in our normative income tax system.

Further, the creation of the proposed excise tax subjects corporate taxpayers to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction in question to unrelated matters regarding the taxpayer's use of a tax adviser and the details of its relationship with the adviser. As such, the provision constitutes an unwarranted intrusion into the manner in which corporate taxpayers conduct their business affairs. In addition, the provision not only discourages, but actually stigmatizes, the willingness of qualified tax advisers to stand behind the quality and accuracy of their professional services.

E. Preclude taxpayers from taking tax positions inconsistent with the form of their transactions.

1. Treasury proposal.

The proposal generally would provide that a corporate taxpayer could not take any position on its return or refund claim that the income tax treatment of a transaction differs from that dictated by its form if a "tax-indifferent party" has an interest in the transaction. The form of a transaction would be determined based on all facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A "tax indifferent party" would be defined to include foreign persons, Native American tribal organizations, tax-exempt organizations, and domestic corporations with expiring loss or credit carryforwards. The proposal would be effective for transactions entered into on or after the date of first committee action.

2. Analysis.

The prevalent theme of this proposal is an approach of "heads I win, tails you lose."

The Administration's proposal would turn upside down the most sacred of all tax doctrines: the tax treatment of a transaction should be based on its substance, and not its form, when its form does not properly reflect its substance. While some courts have said that there are restrictions on when a taxpayer may take a position contrary to the form of its own transaction, even those courts have not imposed an absolute prohibition. If the form chosen by the taxpayer has economic substance, then the taxpayer generally may not assert that the transaction should be taxed in accordance with a different form. However, if the taxpayer can show that the form chosen does not reflect the economic substance of the transaction, then a court generally will evaluate the merits of the taxpayer's claim.

In cases where the tax treatment of a transaction is derived from a written agreement between a taxpayer and a third party, courts have been more hesitant to entertain a substance-over-form argument made by the taxpayer. In these cases, the economic relationship between the taxpayer and other party is established primarily by the agreement itself, rather than independent evidence. The most typical case involves an allocation of the purchase price among various assets after the taxable acquisition of a business. Courts essentially have incorporated the "parol evidence" rule from applicable State law into the tax law. In some circuits, this means that the taxpayer may assert substance over form only with "strong proof." Other circuits, following the so-called "*Danielson* rule," hold that the taxpayer may assert substance over form only with proof that would render the agreement unenforceable (e.g., proof of mistake or fraud). Courts have limited the application of the strong proof rule or the *Danielson* rule to cases involving a written agreement between two parties, where the Service is confronted with potentially conflicting tax claims and thus a potential whipsaw.

The Treasury proposal essentially is a drastic expansion of the *Danielson* rule with an unusual twist. First, the proposed rule prohibiting taxpayers from asserting substance over form would not be limited to cases involving an economic relationship set forth in a written agreement with a third party; rather, it would apply to any transaction where a taxpayer has chosen a particular form. Second, the proposal would apply where there are no potentially conflicting tax claims, and thus no potential for whipsaw, contrary to the approach adopted by the courts.

The fact that a taxpayer, under the proposal, could disclose on its return that it was treating a transaction differently than the transaction's form does not answer these criticisms. The meaning of "form" would be unclear in many circumstances. Does "form" refer to the label given to the transaction or instrument, or does it refer to the rights and liabilities set forth in the documentation? For example, if an instrument is labeled debt, but has features in the documentation typically associated with an equity interest, is the form debt or equity?

Recent attention has been given to Canadian exchangeable share transactions, in which a U.S. corporation acquires a Canadian corporation and the Canadian shareholders retain shares in the Canadian target that are exchangeable for shares in the U.S. acquiror. These shares appear in form to be shares in the Canadian target but in substance may have legal and economic rights equivalent to shares in the U.S. acquiror. One commentator recently suggested that taxpayers structuring these transactions and treating these instruments as shares in the Canadian target are taking positions contrary to the "form." However, this seems to be a classic case where the Service would be asserting that the form of the transaction (i.e., shares in the Canadian target) does not reflect its substance (i.e., shares in the U.S. acquiror). The issue should not be what the form of the transaction is but rather what the substance is.

This proposal would have the unfortunate effect of forcing the taxpayer and the Service to fight over the characterization of a transaction's form, when they ought to be debating the substance of the transaction. The proposal does not subject the Service to the same rule, i.e., the Service would not be precluded from asserting substance over form.

F. Tax income from corporate tax shelters involving tax-indifferent parties.

1. Treasury proposal.

The proposal would impose tax on "tax-indifferent parties" on income allocable to such a party in a corporate tax shelter, effective for transactions entered into on or after the date of first committee action.

2. Analysis.

This proposal ignores the fact that many businesses operating in the global economy are not U.S. taxpayers, and that in the global economy it is increasingly necessary and common for U.S. companies to enter into transactions with such entities. Moreover, the fact that a tax-exempt person earns income that would be taxable if instead it had been earned by a taxable entity cannot in and of itself be viewed as objectionable by the government—if that were the case, the solution simply would be to repeal all tax exemptions. This overreaching Treasury proposal cannot be justified on any tax policy grounds.

Invocation of a rule that would impose tax on otherwise nontaxable persons should require some greater evidence of tax abuse than the mere fact that one of the parties is a foreign person or a tax-exempt entity. The only limit on the application of this proposed rule would be the basic definition of a corporate tax shelter, but as discussed elsewhere in this testimony, that overbroad definition and the nearly unfettered authority contained in the proposal likely would cover many routine business arrangements.

Moreover, as it applies to foreign persons in particular, the provision is overbroad in two significant respects. First, treating foreign persons as tax-indifferent ignores the fact that in many circumstances they may be subject to significant U.S. tax, either because they are subject to the withholding tax rules, because they are engaged in a U.S. trade or business, or because their income is taxable to their U.S. shareholders. To treat all such persons as by definition tax-indifferent would lead to the application of the tax-indifferent party tax to persons that are already subject to U.S. tax. The coordination of normal U.S. taxes with the special tax-indifferent party tax is not addressed by the proposals, so it is not clear whether it is intended that a second U.S. tax would be collected in such cases. If that is not the intent, then coordination rules would be required, which could create substantial complexity, particularly when the liability for the tax-indifferent party tax is imposed on other parties to the transaction.

Second, limiting the collection of the tax to parties other than treaty-protected foreign persons does not hide the fact that the tax-indifferent party tax would constitute a significant treaty override. Collecting the tax-indifferent party liability from other parties would function purely as a collection mechanism, much like a withholding tax, but it is the income of the foreign person that would be subject to the tax.[23] Imposing such a tax on treaty-protected income remains inconsistent with treaty obligations regardless of the collection mechanism adopted. Such a treaty override seems doubly objectionable in a context in which the tax avoidance about which Treasury is concerned is not that of the treaty-protected foreigner, but rather that of another taxpayer. Thus, while Treasury and Congress may conclude that in certain circumstances a treaty override is required to advance significant U.S. tax policy goals, this misguided and unnecessary provision does not justify the serious damage to treaty relationships that it would engender.

III. POTENTIAL IMPACT OF TREASURY PROPOSALS ON LEGITIMATE BUSINESS TRANSACTIONS

The overreaching and vague Treasury Department proposals would have a severely detrimental impact on tax analysis and planning relating to a large number of legitimate business transactions. The proposals contemplate that many of the provisions would apply whenever a corporate tax shelter (as newly defined) is found to exist, even if the taxpayer's position is substantively correct under the Code, regulations, and case law.[24] By contrast, the current-law tax shelter penalty provisions come into play only if the taxpayer initially is found to have understated its tax liability.

Faced with the regime of draconian sanctions proposed by Treasury, taxpayers would find it difficult to make business decisions with any certainty as to the tax consequences, since even a correct application of existing rules could be overturned based on a finding that a transaction worked an "improper deferral" or a "significant reduction of tax." Our testimony below presents only a few of the examples that could be cited of normal business transactions that could be caught in the web woven by the new proposals.

A. International transactions.

1. Debt capitalization of U.S. subsidiary of foreign parent.

Something as basic as the capital structure of a company can be said to reduce the tax on the company's economic income. For example, if the foreign parent of a U.S. subsidiary chooses to capitalize the subsidiary with significant debt, the U.S. tax liability of the U.S. subsidiary may be reduced substantially, with no effect on the group's economic income. Existing law includes provisions under which the Service can test the legitimacy of the interest deductions claimed by the subsidiary in that situation, including the "earnings stripping" rules under section 163(j), the anti-conduit rules under section 7701(l), various treaty-shopping rules, and common law debt-equity principles. Even if the taxpayer's interest deduction passed all of those hurdles, the Treasury proposals could be interpreted to label the corporation's capital structure as a tax shelter, given the reduction of tax on economic income.

The taxpayer could avoid the tax shelter designation only if it could show that the tax benefit of its interest deduction was "clearly contemplated" under the Code. Thus, notwithstanding all the rules that the tax law has developed to test interest deductions, the final determination of the taxpayer's liability would come down to application of a rule that provides virtually no substantive guidance. When is the tax benefit of a deduction for interest "clearly contemplated" by the Code? Obviously not always, because the Code has many specific rules that limit the extent to which a taxpayer may receive a tax benefit for interest it has paid. If a transaction satisfies those specific provisions of the Code, can its tax benefits safely be described as "clearly contemplated" within the meaning of the proposed tax shelter provisions? Presumably not, because Treasury considers its proposal to be a significant change

[23] Depending on the terms of the relevant contractual arrangements, the other participants who paid the tax on the income of the foreign person might well seek to recover that tax from the foreign person.

[24] This follows from the facts that the trigger for applying several of the proposed sanctions (other than the understatement penalty) is the mere existence of a corporate tax shelter, and that the definition of a corporate tax shelter does not appear to exclude any arrangement based on the substantive correctness of the positions taken by the taxpayer. Sanctions that could be invoked on this basis include the denial of tax benefits under section 269, the denial of deductions for fees paid, the excise tax on fees received, and the excise tax on tax benefit guarantees. Indeed, it would appear that by permitting the denial of benefits under section 269 without reference to substantive correctness, the Treasury proposal then could come full circle and impose an understatement penalty on the taxpayer even though its position had been shown to be substantively correct in the first instance.

to current law, so as to permit the Service to prevail in circumstances in which it could not prevail under existing law.

Thus, under the Treasury proposals, taxpayers are left with the uneasy sense that some interest deductions that satisfy all current substantive tax provisions must be "clearly contemplated," and hence are safe from further scrutiny under this proposal as corporate tax shelters, while other interest deductions would not so qualify. The taxpayer, however, would have no idea how to distinguish between them. Moreover, taxpayers and the Service often would disagree over when a benefit was "clearly contemplated." In the case of a debt-capitalized U.S. subsidiary, the Service might well argue that in its opinion the benefit received (namely, the interest deduction) exceeds that which was "clearly contemplated" by Congress.

To complicate matters further, the likelihood of a "not clearly contemplated" attack may be greater in the context of a cross-border transaction. While the current Treasury explanation of its proposals does not discuss extensively the use of hybrid entities or instruments,[25] previous Treasury proposals suggest that the presence of a cross-border hybrid likely would affect Treasury's analysis. For example, suppose that the debt instrument giving rise to the U.S. subsidiary's interest deduction was viewed as stock by the parent's home country, so that the payments were viewed as dividends that received favorable tax treatment in that jurisdiction.[26] Would the Service argue that the benefit of the subsidiary's interest deduction is "clearly contemplated" only when the payment is viewed as interest in the hands of both the payor and the payee? Treasury pronouncements to date provide no clear answer, having suggested, for example, that inconsistent cross-border characterizations leading to the recognition of a foreign tax credit in two jurisdictions simultaneously may be abusive in Treasury's view, while the simultaneous recognition of depreciation deductions in two jurisdictions has been viewed by Treasury as appropriate.[27]

Accordingly, a foreign parent faced with the need to determine the capital structure for its U.S. operations would find it extraordinarily difficult to predict its U.S. tax treatment with any certainty. Even if a cross-border transaction complies with all existing rules, and regardless of whether the transaction tries to achieve any cross-border arbitrage, a company always would face the possibility of a Service challenge that would deny the benefit of its deductions and impose several other sanctions based on interpretations of the "corporate tax shelter" definition. Adding this type of fundamental uncertainty to the already extreme complexity of the Code cannot be defended as appropriate tax policy.

2. Foreign tax reduction

As a threshold matter, it is not clear whether the Treasury proposal is limited to avoidance of U.S. as opposed to foreign taxes. The proposals are drafted broadly in terms of "a tax benefit in a tax avoidance transaction," "a significant reduction of tax," etc. Recent Treasury Department activities should make it clear that the inquiry is a serious one, since IRS Notice 98–11 establishes that Treasury may be as concerned about avoidance of foreign taxes as about U.S. taxes. This follows from the fact that the Notice would treat otherwise identical transactions differently, depending on whether the effect of the transaction was to achieve a reduction of foreign tax.[28]

The new tax shelter proposals would seem to give Treasury authority to deny tax benefits in connection with any arrangements entered into by a U.S.-based multinational in connection with the debt-capitalization of its foreign operations, or indeed any transaction or structure that had the effect of significantly reducing foreign taxes. The uncertainty would be further compounded by the issue of hybrid status discussed above—would the Service be more likely to challenge a foreign tax-reduction structure with hybrid elements? For example, would a "hybrid branch" within the meaning of Notice 98–11 be more susceptible to challenge than a conventional branch that had the same tax effect (i.e., foreign tax reduction with no sub-

[25] There is an oblique reference to hybrid arrangements in connection with the proposal that would prohibit taxpayers from taking a position that is inconsistent with the form of their transactions.

[26] For example, the parent might receive a foreign tax credit for the underlying U.S. corporate tax paid by the U.S. subsidiary, or the dividends might be eliminated through a "participation exemption" or similar regime.

[27] See Notice 98–5 and the Administration's 1998 budget proposals.

[28] The Notice proposes rules that would trigger subpart F inclusions with respect to payments involving hybrid branches only if such payments had the effect of reducing foreign taxes. The policy debate concerning the substantive treatment set forth in the statute is beyond the scope of this testimony—it should suffice for our purposes here to note that Treasury does seem to object to foreign tax reduction by U.S. taxpayers.

part F inclusion)? The question cannot be answered based on the proposals themselves or any other Treasury guidance.

Accordingly, enactment of the Treasury proposals would throw the structuring of international operations of U.S. companies into complete tax uncertainty—the tax consequences of many transactions and investments would not be determinable until long after the fact, since their tax results could not be determined based on the existing Code, regulations, or case law. Instead, the taxpayer would have to wait until Service revenue agents reviewed the transactions and determined whether they were offended by any particular aspect, regardless of the extent to which the transaction complied with existing law. This discretion and the unprecedented complexity and uncertainty it would cause cannot be justified on any tax policy principle.

3. Foreign tax credits in high-tax settings.

If the Treasury proposals were enacted, a U.S.-based multinational could find itself in a remarkable whipsaw. Efforts to reduce foreign taxes could trigger a response of the Service based on Notice 98–11 type concerns; on the other hand, failure to reduce foreign taxes potentially could subject the taxpayer to scrutiny based on the fact that the resulting foreign tax credits were deemed disproportionate to its economic income. This follows from the Treasury proposal defining a tax shelter to include any arrangement in which pre-tax profits are insignificant in relation to net tax benefits. By selectively defining the relevant "transaction," the Service could determine that any particular activity in a foreign jurisdiction produced limited net income, and thus that such income was "insignificant" in relation to the foreign tax credits associated with it. This problem is particularly acute in the case of financial institutions that may engage in a portfolio of transactions, some of which could be isolated and shown to be economic losses. But the problem also could be faced by any business with multiple product or service lines of varying profitability.

Further, even in the case of an activity with "normal" profits, foreign tax base or timing differences could increase artificially the apparent foreign tax rate to the point where the economic profit would appear to be insignificant by comparison. With tax base and timing differences, a normal business scenario could produce a foreign tax rate that looks high enough that the economic profit could be viewed as not substantial relative to the foreign tax credit benefits.

Moreover, by treating foreign taxes paid as an expense like any other, the proposals misconceive and distort the role of the foreign tax credit in the U.S. tax system. By treating foreign taxes as an expense, Treasury is in effect positing that the correct standard for identifying an abuse is to ask whether the taxpayer would carry out a transaction if it did not receive a foreign tax credit at all—in other words, a transaction should be viewed as proper only if it makes economic sense without regard to any foreign tax credits.

This cannot be right in view of the fundamental purpose of the foreign tax credit. Most foreign business operations conducted by U.S.-based taxpayers in jurisdictions that impose significant taxes probably would be untenable in the absence of a U.S. credit for those foreign taxes. Does the Treasury proposal mean that all U.S.-owned controlled foreign corporations in Germany, Japan, Italy, France, and the United Kingdom, among other countries, represent corporate tax shelters? The basic goal of the foreign tax credit is to enable U.S.-based companies to conduct overseas activities without suffering double taxation, and that function is served by treating a foreign tax as if it were a U.S. tax (up to the U.S. rate). Thus, adopting a definition of tax shelter that takes as its analytical starting point a world in which no foreign taxes are creditable is inconsistent with the fundamental operation of U.S. international tax rules as they have operated for decades.

In sum, the Treasury proposals would make the U.S. tax results of cross-border transactions largely unknowable. Transactions that satisfied the requirements of all existing statutory, regulatory, and judicial standards nevertheless could be challenged by the Service under standards of utter vagueness. They could be attacked for paying too little foreign tax, or for paying too much. They could be targeted for violating nebulous policy concerns, such as those with respect to hybrids, that Treasury has not yet managed to articulate fully.

This fundamental tax uncertainty would deprive U.S. businesses of the ability to make rational cross-border business decisions, disrupting international trade and investment at a time when the growth of a global economy has made them an increasingly important component of U.S. economic prosperity. Finally, the Treasury proposals would damage U.S. international tax policy by abandoning some of its fundamental precepts, and do broader damage to U.S. tax policy in general by seeking to replace known legal standards with a regime governed solely by administrative edict.

B. Corporate transactions.

1. In general.

There is a lengthy list of legitimate merger and acquisition transactions that could be caught by Treasury's proposed broad definition of "tax avoidance transaction." For example, tax-free reorganizations involving small corporations acquired by large corporations or spin-off transactions involving unequal amounts of debt allocated between the separated entities might be treated by the Service as "tax avoidance transactions." The nearly unfettered ability of the Service to recharacterize the tax effects of legitimate corporate transactions would cause considerable uncertainty in many cases of prudent and appropriate tax structuring of transactions.

By contrast to the haphazard manner in which the rules for taxing corporate transactions would develop under the Treasury proposals, current law consists of statutory, regulatory, and judicial doctrines that have been refined and developed over time and that provide guidance and appropriate tax results in corporate transactional planning.

2. Reasons for concern.

Broad anti-abuse rules like the Treasury proposals can adversely affect the ability of corporations to engage in legitimate business transactions by bringing the tax consequences of ordinary transactions into question. Given the Service's limited resources, such disputes may not be resolved satisfactorily through ordinary avenues such as the private letter ruling process.

The development of the tax law regarding transfers of property outside the United States provides a relevant example. Prior to 1984, section 367(a) required transferors of property to foreign persons to receive permission from the Service, in the form of a private letter ruling, in order for the transfer to qualify as a nontaxable transaction. This was to ensure that the principal purpose of the outbound transfer was not tax avoidance. By requiring that taxpayers get advance approval before making an outbound transfer of assets, taxpayers were precluded from completing a transaction and determining in later litigation, if necessary, the question of whether tax avoidance was one of the principal purposes of the transaction. Under these rules, Treasury was able to prevent taxpayers from undertaking legitimate business transactions simply by declining to issue a favorable private letter ruling.

To remedy this inequity, the Tax Reform Act of 1976 established a special declaratory judgment procedure (section 7477) allowing taxpayers to immediately litigate the Service's section 367 determinations in the Tax Court. Under the procedure, the taxpayer was able to have the dispute reviewed by the Tax Court if it was demonstrated that a request had been made to the Service for a determination and that the Service either failed to act or acted adversely. After a number of taxpayer-favorable decisions, Congress replaced this system in 1984, and today taxpayers are not required to obtain a private letter ruling in advance of a section 367 transaction.

Obviously, requiring taxpayers to obtain prior approval from Treasury for legitimate business transactions proved to be an unworkable process. In order for a voluntary tax system to work in a global economy, taxpayers must be able to implement their business strategy while providing a review process that ensures appropriate and consistent tax treatment for all. The Treasury proposals, by creating general corporate anti-abuse rules without guidelines or restrictions, would result in uncertainty for taxpayers engaging in ordinary corporate transactions and generally would burden taxpayers with the responsibility of litigating disputes with the Service over the limits of the anti-abuse rules themselves.

C. Partnership transactions.

As the globalization of the world economy continues, many companies are turning to partnership joint ventures as a preferred business form to conduct new business operations. Such joint ventures provide immediate access to technology, financing, new markets, and human capital that otherwise might take years for a company to develop internally. The reach of Treasury's tax shelter proposals seriously jeopardizes this legitimate joint-venture activity.

Many joint ventures are speculative in nature. Pre-tax profits are anticipated but may be longer term, and the investment's ultimate rate of return is uncertain. It is quite common for joint ventures to generate economic losses in formative years; these "tax benefits" could be significant when compared to reasonably expected pre-tax profits at the outset of the joint venture.

The breadth of the Treasury's proposed definition of a tax shelter quite likely would impose an in terrorem effect in the formation of joint ventures with marginal rates of return because of increased uncertainty created by the potentially broad reach of the new proposals. The consequence would be a lack of competitiveness by U.S. companies in the global market.

In certain industries, partnerships are used to spread the risk of research. These research partnerships, which generate little in short-term profits, are economically viable because of the potential intellectual capital created in the long term. Conceivably, under the Administration's definition of tax shelters, the Service would be put in the position of second-guessing the economics of a particular research partnership, causing the parties to justify anticipated pre-tax profits in light of failures to generate viable new technology. Fear of Service challenges to what are otherwise legitimate business decisions could well dampen the kind of research U.S. companies undertake.

Oil and gas exploration depends on huge amounts of capital generated through the formation of partnerships. This industry can be wildly speculative. If the Treasury tax shelter proposals were adopted, the Service effectively would sit side-by-side with the wildcatters in assessing what wells can be drilled in order to avoid these activities later being defined as a tax shelter.

Consider, for example, the case of an independent oil and gas operator that frequently engages in searches for oil on undeveloped and unexplored land that is not near proven fields. The taxpayer engages in a particular speculative wildcat oil-drilling venture at an anticipated cost of $5 million. Based on the experience of taxpayers engaging in this type of business, there is a 90-percent chance that the taxpayers will not find a commercially profitable oil deposit and that the entire $5 million investment will be lost. There is a 10-percent probability that the venture will produce pre-tax economic profits in the average probability-weighted amount of $40 million. Under the Treasury proposals, the Service might treat the venture as a corporate tax shelter on the ground that the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits.

The real estate industry also relies heavily on partnership vehicles. In the case of real estate investment trusts (REITs), lower-tier partnerships routinely are used to acquire new properties from sellers interested in diversifying their own investment portfolios. The proposed definition of a tax shelter would cause reassessments of what properties a REIT can invest in because, more often than not, a particular real estate deal will be speculative in nature.

Other industries that use the partnership vehicle to aggregate capital for investment purposes include venture capital funds and investment partnerships. Both generate capital to be invested in other businesses for higher and sometimes speculative rates of return. An overbroad and vague tax shelter definition may well alter the types of investments made at the margin by these industries.

Investment decisions are made all the time by competent business executives and investors. Unfortunately, Treasury's misguided tax shelter proposals would call into question many of their investment decisions. Injecting the Service into what are otherwise legitimate business decisions would create an unintended and detrimental drag on our robust economy.

D. OTHER ILLUSTRATIONS.

As discussed above, the Treasury proposals would discourage taxpayers from undertaking beneficial but unprofitable activities that, absent legitimate tax incentives, they would not perform. Such activities particularly are vulnerable to being tagged as tax shelters because they literally could be viewed as arrangements in which a "corporate participant attempts to obtain a tax benefit in a tax avoidance transaction."

As one example of the potential chilling effects of the Treasury proposals, legislation enacted in 1997 allows taxpayers to deduct certain costs of cleaning up economically depressed sites, known as "brownfields." The legislation sought to encourage taxpayers to clean up sites that otherwise might prove too costly or uneconomical to clean up. Under the tax shelter proposal, a taxpayer's attempt to deduct cleanup costs whose treatment is not clear under the brownfields statute could be treated as a tax shelter.

The claimed deductions might constitute a "tax benefit" under the proposal because certain deductions while potentially permissible may not be deemed "clearly contemplated by the applicable provision" (emphasis added). Moreover, the taxpayer's cleanup activities could be considered a "tax avoidance transaction" because the taxpayer's pre-tax profit from cleaning up a site probably would be insignificant relative to its reasonably expected tax benefits. Thus, a taxpayer that cleans up a brownfields site and claims a deduction for its costs could face a serious risk of being treated as a tax shelter participant merely because the treatment of some of those costs is less than clear under the statute. Treasury may well respond that it does not intend to impact detrimentally the recently enacted "brownfields" statute. The fact remains that the overbroad reach of the Treasury proposals could call into question the tax effect of this provision and many other normal business transactions and activities.

Besides the examples set forth above, numerous ordinary business transactions could be affected by the Treasury proposals. These could include certain hedging transactions, certain sale-leaseback transactions, various corporate distributions, and certain transactions between joint venture entities.

IV. ADEQUACY OF EXISTING TOOLS TO ADDRESS "ABUSE"

A. CURRENT PENALTIES AND REGISTRATION REQUIREMENTS RELATING TO TAX SHELTERS.

The chief tax executive of a corporation has several duties and responsibilities in the tax analysis, collection, and enforcement process.[29] Some are derived from the tax executive's fiduciary duties to shareholders to preserve and protect corporate assets, including a duty to protect corporate assets from unnecessary additions to tax through the imposition of penalties.

The existing penalty structure in the Code is a burdensome and complex patchwork of rules that present the chief tax executive with considerable uncertainty in determining their application and scope. The corporate tax executive must consider carefully the possible application of those penalties prior to implementing any particular course of action.

Three broad types of penalties potentially apply with respect to tax shelters: (1) the accuracy-related penalty under section 6662, which is applicable to underpayments of tax resulting from certain types of conduct, (2) tax shelter-specific penalties such as those applicable to promoters of abusive tax shelters and to the failure to register or furnish information regarding tax shelters, and (3) penalties related to the preparation or presentation of tax returns, claims, or other documents reporting the benefits or attributes of tax shelter items. A list of these penalty provisions is contained in Appendix A.

1. Accuracy-related penalty.

One of the most significant penalties that a chief tax executive must consider in analyzing any transaction is the accuracy-related penalty under section 6662. That penalty is imposed on any portion of an underpayment attributable to one or more of the following:

- negligence or disregard of rules and regulations;
- any substantial understatement of income tax;
- any substantial valuation misstatement;
- any substantial overstatement of pension liabilities; or
- any substantial estate or gift tax valuation understatement.

The penalty equals 20 percent of the portion of the underpayment attributable to the specified conduct. The first three components of the accuracy-related penalty (i.e., the negligence/intentional disregard, substantial understatement, and valuation misstatement components) are the most relevant to potential tax shelter transactions.

Pursuant to section 6664(c), the accuracy-related penalty will not be imposed on any portion of an underpayment if the taxpayer shows there was a reasonable cause for the underpayment and that the taxpayer acted in good faith with respect to such portion. The determination of whether a taxpayer acted with "reasonable cause and in good faith" is made on a case-by-case basis, taking into account all pertinent facts and circumstances, the most important of which is the extent of the taxpayer's efforts to assess its proper tax liability. As a general rule, it is more difficult to establish the existence of reasonable cause when the underpayment of tax is attributable to true tax shelter activities.

a. Definition of "tax shelter" for purposes of the accuracy penalty rules.—For purposes of the accuracy-related penalty imposed by section 6662, the term "tax shelter" means a partnership or other entity (e.g., a trust), an investment plan or arrangement, or any other plan or arrangement the purpose of which is to avoid or evade federal income tax. Congress significantly broadened the scope of these rules in the Taxpayer Relief Act of 1997, to treat an entity, plan, or arrangement as a

[29] A detailed description of the responsibilities and burdens of a chief tax executive is set forth in Part V of these comments.

tax shelter if one of its *significant* purposes is tax avoidance or evasion.[30] The Service and Treasury have not yet issued guidance regarding the definition of the term "significant purpose."

The broadened definition of the term "tax shelter" for accuracy-related penalty purposes under the 1997 Act is a powerful tool that the Treasury and the Service can utilize to respond to perceived avoidance situations. The failure, however, to provide necessary guidance under that statute, in the form of regulations or otherwise, has made it extremely difficult for chief tax executive to analyze and evaluate potential transactions so as to protect against the imposition of such penalties.

b. Negligence or disregard of rules or regulations.—A 20-percent accuracy-related penalty is imposed on the amount of any underpayment that is attributable to negligence or the disregard of rules or regulations. Negligence includes any careless, reckless, or intentional disregard of rules or regulations, any failure to make a reasonable attempt to comply with the provisions of the law, and any failure to exercise ordinary and reasonable care in the preparation of a tax return. In other words, negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Disregard of rules or regulations means any careless, reckless, or intentional disregard of the Code, regulations (final or temporary), or revenue rulings or notices published in the Internal Revenue Bulletin.[31]

Negligence includes the failure to keep adequate books and records or to substantiate items properly.[32] A position with respect to an item is attributable to negligence if it lacks a "reasonable basis."[33] Negligence is strongly indicated where, for example, a taxpayer fails to include on an income tax return an income item shown on an information return, or a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.[34] This prudence standard is imposed on a chief tax executive as he or she analyzes the appropriateness of a particular transaction.

c. Substantial understatement of income tax.—In determining whether it would be prudent to enter into a particular transaction, the corporate tax executive also must consider the component of the accuracy-related penalty that is imposed on the portion of any underpayment that is attributable to a substantial understatement of income tax. An "understatement of tax" is the excess of the amount required to be shown on the return for the tax year less the amount of tax actually shown on the return, reduced by any rebates.

An understatement is "substantial" if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year, or (2) $10,000 (in the case of a corporation other than an S corporation or a personal holding company).

d. Substantial valuation misstatement.—A 20-percent accuracy-related penalty also is imposed on the portion of any underpayment of tax attributable to a substantial valuation misstatement with respect to the value or adjusted basis of property reported on any return. In the case of a gross valuation misstatement, the penalty is increased to 40 percent. These penalties apply if the aggregate of all portions of the underpayment attributable to the misstatement exceeds $10,000 for corporations other than S corporations or a personal holding company.[35] This aspect of the accu-

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[30] Section 6662(d)(2)(C)(iii). Prior law defined tax shelter activity as an entity, plan or arrangement only if it had as its *primary* purpose the avoidance or evasion of tax.

[31] Treas. Reg. section 1.6662–3(b)(2).

[32] Treas. Reg. section 1.6662–3(b)(1).

[33] Pursuant to Treas. Reg. section 1.6662–3(b)(3), the "reasonable basis" standard is a relatively high standard of tax reporting and is not satisfied by a return position that is merely arguable or merely a colorable claim. A return position generally satisfies the standard if it is reasonably based on one or more of the authorities set forth in Treas. Reg. section 1.6662–4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even though it may not satisfy the substantial authority standard as defined in Treas. Reg. section 1.6662–4(d)(2).

[34] Treas. Reg. section 1.6662–3(b).

[35] Section 6662(e)(1) provides that a valuation misstatement is substantial if: the value or adjusted basis of any property claimed on any income tax return is 200 percent or more of the correct value or adjusted basis; or (a) the price for any property or services (or for the use of property) in connection with any transaction between trades or businesses owned or controlled, directly or indirectly, by the same interests (as described in section 482) is 200 percent or more (or 50 percent or less) of the amount determined to be the correct amount of such price, or (b) in tax years beginning after December 31, 1993, the net section 482 transfer price adjustment for the tax year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts. Pursuant to section 6662(h)(2), a gross valuation misstatement occurs where: the value or adjusted basis of any property claimed on any return is 400 percent or more of the amount deter-

racy-related penalty regime has received renewed emphasis and review by corporate tax executives in light of the Tax Court's recent decision upholding the Service's imposition of the 40-percent penalty.[36]

e. Concluding analysis.—In sum, the accuracy-related penalty provides a powerful incentive for corporate tax executives to review closely and analyze both the structure and the implementation of any proposed business transaction that results in tax benefits, and to impose prudence on the decision-making process. This penalty, and the overall penalty regime, can be made much clearer and more precise so as to provide corporate tax executives with certainty in analyzing particular transactions. To this end, the ongoing studies aimed at reviewing and potentially streamlining the current complex and burdensome penalty system hold the potential for meaningful improvements.[37] At this time, there is no demonstrated justification for increasing the penalties and adding further uncertainty to the process as contemplated by the Treasury proposals.

2. Penalties imposed on tax shelter promoters.

The Code contains a number of penalties applicable to tax shelter promoters. These promoter penalties collectively form a "safety net" to ensure that tax shelter activities are not promoted and that misinformation about proper tax rules is not disseminated by unscrupulous advisors. It is highly unlikely that a prudent tax executive of a large corporation seriously would consider entering into the sort of abusive transaction for which promoter penalties would be applicable. Accordingly, the penalties are briefly described below to illustrate that the Code already contains a number of safeguards against abusive tax planning activities.

a. Penalty for promoting abusive tax shelters.—Under section 6700(a), a civil penalty—equal to the lesser of $1,000 or 100 percent of the gross income derived (or to be derived) by the particular promoter from the activity—may be imposed against persons who promote abusive tax shelters. The term "promoting" encompasses organizing such tax shelters, participating directly or indirectly in their sale, and making or furnishing (or causing another person to make or furnish) certain false or fraudulent statements[38] or gross valuation overstatements[39] in connection with their organization or sale. Pursuant to section 7408, the Service also can obtain an injunction against such promoters to enjoin them from further promotion activity.

b. Aiding and abetting penalty.—The Service may impose a penalty under section 6701 of $1,000 ($10,000 with respect to corporate tax returns and documents) against any person who (1) aids, assists, or gives advice in the preparation or presentation (e.g., during a Service examination) of any portion of a tax return, affidavit, claim, or other document; (2) knows (or has reason to believe) that the portion of the return or document will be used in connection with any material matter arising under the internal revenue laws; and (3) knows that, if the portion of the tax return or other document is used, an understatement of another person's tax liability would result.

In addition, disciplinary action may be taken against any professional appraiser against whom an aiding and abetting penalty under section 6701(a) has been imposed with respect to the preparation or presentation of an appraisal resulting in an understatement of tax liability.

3. Penalties for failure to furnish information regarding tax shelters.

a. Penalty for failure to register a tax shelter.—An organizer of an entity, plan, or arrangement that meets the definition of a tax shelter under section 6111 who fails to timely register such shelter, or who files false or incomplete information with such registration, is subject to a penalty under section 6707(a). The penalty

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mined to be the correct value or adjusted basis; or (a) the price for any property, or for its use, or for services, claimed on any return in connection with a transaction between persons described in section 482 is 400 percent or more (or 25 percent or less) of the amount described in section 482 to be the correct amount of such price, or (b) in tax years beginning after December 31, 1993, the net section 482 transfer price adjustment for the tax year exceeds the lesser of $20,000,000 or 20 percent of the taxpayer's gross receipts.

[36] DHL Corp. v. Comm'r, T.C. Memo. 198–461, December 30, 1998.

[37] The penalty studies were required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998.

[38] A statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. Section 6700(a)(2)(A).

[39] A gross valuation overstatement is a statement as to the value of property or services that is directly related to the amount of any income tax deduction or credit, provided that the value exceeds 200 percent of the correct value. Section 6700(a)(2)(B).

equals the greater of (1) $500 or (2) one percent of the amount invested in the shelter.

The penalty for failing to register a "confidential corporate tax shelter," as defined in section 6111(d) (as amended by the Taxpayer Relief Act of 1997), is the greater of (1) $10,000, or (2) 50 percent of the fees paid to all promoters with respect to offerings prior to the date of the late registration. The penalty applies to promoters and to actual participants in any corporate tax shelter who were required to register the tax shelter but failed to do so. For participants, the 50-percent penalty is based solely on fees paid by the participant. The penalty is increased to 75 percent of applicable fees where the failure to register the tax shelter is due to intentional disregard on the part of either a promoter or a participant.[40]

b. Penalty for failure to furnish tax shelter identification numbers.—Pursuant to section 6707(b)(1), a person who sells an interest in a tax shelter and fails to furnish the shelter's identification number to each investor in the shelter is subject to a monetary penalty unless the failure is due to reasonable cause. Section 6707(b)(2) provides that an investor who fails to furnish the shelter's identification number on a return reporting a tax item related to the tax shelter also is subject to penalty.

c. Penalty for failure to maintain lists of investors in potentially abusive tax shelters.—Pursuant to section 6708, any person who is required to maintain a tax shelter customer list, as required by section 6112, and who fails to include any particular investor on the list will be assessed a penalty for each omission unless it is shown that the failure results from reasonable cause and not from willful neglect. The maximum penalty for failure to maintain the list is $100,000 per calendar year. This penalty is in addition to any other penalty provided by law.

4. Tax return preparer penalties.

Section 6694(a) provides that if any part of an understatement of liability with respect to a return or claim for refund is due to a position that did not have a realistic possibility of being sustained on its merits[41] and an income tax return preparer with respect to that return or claim knew (or reasonably should have known) of that position, the preparer is subject to a penalty of $250 with respect to the return or claim, unless it is shown that there is reasonable cause for the understatement and that the preparer acted in good faith. The penalty will not apply if the position (1) was adequately disclosed and (2) is not frivolous.[42]

If the preparer establishes that an understatement attributable to an unrealistic position was due to reasonable cause and that the preparer acted in good faith, the preparer penalty will not be imposed. This determination depends upon the facts and circumstances of the particular case, including the nature of the error, the frequency and materiality of the error, the preparer's normal office practices, and reliance on any other preparer's advice.[43]

5. Registration requirements.

Section 6111 requires tax shelter organizers[44] to register tax shelters with the Service by the day on which the first offering for sale of interests in the tax shelter occurs.[45] Pursuant to section 6111(d), which was added by the Taxpayer Relief Act

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[40] Section 6707(a)(3).

[41] A position is considered to satisfy the realistic possibility standard if a reasonable and well-informed analysis by a person knowledgeable in tax law would lead that person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits. Treas. Reg. section 1.6694–2(b)(1). In determining whether a position has a realistic possibility of being sustained, the relevant authorities are the same as those considered in determining whether, for purposes of the accuracy-related penalty, there is substantial authority for a tax return position. Treas. Reg. section 1.6694–2(b)(2).

[42] A frivolous position is one that is patently improper. Treas. Reg. section 1.6694–2(c)(2).

[43] Treas. Reg. section 1.6694–2(d).

[44] The term "tax shelter organizer" is defined as the person who is principally responsible for organizing a tax shelter ("the principal organizer"), i.e., any person who discovers, creates, investigates, or initiates the investment, devises the business or financial plans for the investment, or carries out those plans through negotiations or transactions with others. Temp. Treas. Reg. section 301.6111–1T, A–27.

[45] The temporary regulations provide that certain investments will not be subject to tax shelter registration even if they technically meet the definition of a tax shelter. The following investments are not subject to registration: (1) sales of residences primarily to persons who are expected to use the residences as their principal place of residence, and (2) with certain exceptions, sales or leases of tangible personal property by the manufacturer (or a member of an affiliated group) of the property primarily to persons who are expected to use the property in their principal active trade or business. By Notice, the Service may specify other investments that are exempt from the registration requirement. Temp. Treas. Reg. section 301.6111–1T, A–24. In addition, the tax shelter registration requirements are suspended with respect to any tax shelter

of 1997, certain "confidential arrangements" are also treated as tax shelters for purposes of the registration requirements. Those provisions, however, are not effective until the Service or Treasury issues guidance with respect to the 1997 Act amendments to the registration requirements. To date, no such guidance has been issued. The Service and Treasury, therefore, have failed to take advantage of what would appear to be a potent weapon in the Government's arsenal to curb abusive tax shelter activity.

In the context of the tax shelter registration requirements, section 6111(d)(1) provides that a "corporate tax shelter" includes any entity, plan, arrangement, or transaction: (1) that has as a significant purpose the avoidance [46] of tax or evasion by a corporate participant; (2) that is offered to any potential participant under conditions of confidentiality; [47] and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

Under the rules applicable to confidential corporate tax shelters, individuals who merely discussed participation in the shelter may in some circumstances be required to comply with the registration requirements. A promoter of a corporate tax shelter is required to register the shelter with the Service not later than the day on which the tax shelter is first offered for sale to potential users. As previously discussed, civil penalties under section 6707 may be imposed for the failure to timely register a tax shelter. Criminal penalties are applicable to willful noncompliance with the registration requirements.[48]

These registration rules, which Treasury and the Service have not yet implemented, as well as the collective impact of the existing complex and disparate penalty regime, render the Treasury proposals unnecessary and inappropriate.

B. Existing "common-law" doctrines.

Pursuant to several "common-law" tax doctrines, Treasury and the Service have the ability to challenge taxpayer treatment of a transaction that they believe is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the Service believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer artificially has divided the transaction into separate steps, (3) the taxpayer has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

These broadly applicable doctrines—known as the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, and the sham transaction and economic substance doctrine—provide the Service considerable leeway to recast transactions based on economic substance, to treat apparently separate steps as one transaction, and to disregard transactions that lack business purpose or economic substance. Recent applications of those doctrines have demonstrated their effectiveness and cast doubt on Treasury's asserted need for additional tools.

Since the enactment of the internal revenue laws, the Service, often with the blessing of the courts, has probed taxpayers' business motives. Such inquiries have led to the development of the "business purpose doctrine," which permits the Service to disregard for federal income tax purposes a variety of transactions entered into without any economic, commercial, or legal purpose other than the hoped-for favor-

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that is a "projected income investment." Generally, a tax shelter is a projected income investment if it is not expected to reduce the cumulative tax liability of any investor for any year during any of the first five years ending after the date on which the investment is offered for sale.

[46] As in the case of the definition of "tax shelter" for accuracy-related penalty purposes, the terms "significant purpose" and "tax avoidance" are not defined or explained for tax shelter registration purposes.

[47] A transaction is offered under conditions of confidentiality if: (1) a potential participant (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit the potential participant's disclosure of the tax shelter or any significant tax features of the tax shelter; or (2) the promoter (a) claims, knows, or has reason to know, (b) knows or has reason to know that any other person (other than the potential participant) claims, or (c) causes another person to claim that the transaction (or any aspect thereof) is proprietary to the promoter or any party other than the potential participant, or is otherwise protected from disclosure or use. Section 6111(d)(2).

[48] See, e.g., section 7203.

able tax consequences. Although the business purpose doctrine originated in the context of corporate reorganizations,[49] it quickly was extended to other areas.[50]

The "substance over form doctrine" often is associated with the business purpose doctrine. Under the substance over form doctrine, a court may ignore the form of a transaction and apply the tax law to the transaction's substance if the court perceives that the substance of a transaction lies within the intended reach of a statute, but that the form of the transaction takes the event outside that reach.[51] Therefore, while a taxpayer may structure a transaction so that it satisfies the formal requirements of the tax law, the Service may deny legal effect to the transaction if its sole purpose is to evade taxation.[52]

The courts have long been willing to elevate substance over form in interpreting a sophisticated code of tax laws where slight differences in a transaction's design can lead to divergent tax results. In the tax law arena, the substance over form doctrine has been used expansively to justify the Service's recasting of transactions.[53] For example, the doctrine has been used to: (1) void reorganizations,[54] (2) reject the assignment of income,[55] (3) recharacterize the sale or transfer of property between related parties,[56] (4) recharacterize sale and leaseback arrangements,[57] (5) disallow interest deductions,[58] and (6) disregard the separate corporate entity.[59]

The "step transaction" doctrine permits the Service to aggregate formally separate transactions into a single transaction. Under the doctrine, tax results are determined by looking at the final result of the various steps of the transaction. The doctrine particularly ignores the intermediate steps in a transaction where those steps primarily were taken for tax purposes.

The "sham transaction" doctrine allows the Service to deny deductions and losses or otherwise recast transactions that lack any economic results beyond a tax deduction. The sham transaction doctrine has been expanded to apply even to certain bona fide transactions, where sufficient economic motivation is lacking.

The recent decisions in *ACM v. Commissioner*[60] and *ASA Investerings v. Commissioner*[61] illustrate the continuing force of these long-standing judicial doctrines. In *ACM*, the Third Circuit, affirming the Tax Court, relied on the sham transaction and economic substance doctrines to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court similarly invoked those doctrines in *ASA Investerings* to disallow losses on the purchase and resale of private placement notes. Both cases involved complex, highly sophisticated transactions, yet the Service successfully used common law principles to prevent the taxpayers from realizing tax benefits from the transactions.

1. The business purpose and substance over form doctrines.

The business purpose and substance over form doctrines continue to serve as powerful tools for the Service to recharacterize a taxpayer's transactions to combat tax avoidance.[62] The business purpose doctrine generally provides that a transaction will not be respected for tax purposes unless it serves some purpose other than tax avoidance. The Supreme Court's decision in *Gregory v. Helvering,*[63] generally is cited as the origin of the business purpose doctrine. In *Gregory*, a reorganization complied with all of the formal statutory requirements, but was disregarded for federal income tax purposes because no valid economic purpose existed for the creation and immediate liquidation of a transferee corporation. The transaction simply was

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[49] *Gregory v. Helvering* [35–1 USTC para. 9043], 293 U.S. 465 (1935), which generally is regarded as the origin of the business purpose doctrine, involved a reorganization motivated by tax avoidance.

[50] In *Commissioner v. Transport Trading & Terminal Corp.* [49–2 USTC para. 9337], 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950), the doctrine was extended to all statutes that describe commercial transactions.

[51] *The Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability*, 49 Fordham L. Rev. 1078, 1080 (1981).

[52] *Stewart v. Commissioner* [83–2 USTC para. 9573], 714 F.2d 977, 987 (9th Cir. 1983).

[53] 49 Fordham L. Rev. at 1080–81 (listing examples and collecting citations).

[54] *Gregory v. Helvering*, *supra* n. 49.

[55] *Helvering v. Horst* [40–2 USTC para. 9787], 311 U.S. 112, 114–120 (1940) (holding that income, rather than income-producing property, had been assigned).

[56] *Commissioner v. Court Holding Co.* [45–1 USTC para. 9215], 324 U.S. 331, 333–334 (1945).

[57] *Frank Lyon Co. v. U.S.* [78–1 USTC para. 9370], 435 U.S. 561 (1978).

[58] *Knetsch v. U.S.* [60–2 USTC para. 9785], 364 U.S. 361 (1960).

[59] *Moline Properties, Inc. v. Commissioner* [43–1 USTC para. 9464], 319 U.S. 436, 438–439 (1943).

[60] 157 F3d 231 (3d Cir. 1998).

[61] [98–2 USTC para. 52,845], T.C.M. 1998–305 (1998).

[62] See, e.g., *ASA Investerings*, *supra*; *ACM Partnership*, *supra*.

[63] *Supra* n. 49.

an attempt to convert ordinary dividend income into capital gains. The Supreme Court's decision was not based on any tax-avoidance motive of the taxpayer, but rather on the lack of a business purpose for the transaction which the statutory scheme contemplated. The court stated:

> The legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from tax motive, was the thing which the statute intended. [293 U.S. at 469]

The Tax Court has noted that the doctrine in *Gregory* is not limited to the field of corporate reorganizations, but has a much wider scope.[64]

The substance over form doctrine, which is closely associated with the business purpose doctrine, generally allows courts to follow the economic substance of a transaction where a court believes the taxpayer's empty form shelters a transaction from the rules that otherwise should govern. As indicated above, the Service has succeeded in using the substance over form doctrine to recharacterize a variety of transactions. Furthermore, the substance over form doctrine offers the Service the added advantage of generally working in the government's favor and not in the taxpayer's.[65]

2. The step transaction doctrine.

Another version of the substance over form concept appears in the "step transaction doctrine," which also applies throughout the tax law. The step transaction doctrine allows the Service to collapse and treat as a single transaction a series of formally separate steps, if the steps are "integrated, interdependent, and focused toward a particular result."[66] Thus, the step transaction doctrine ignores the intermediate steps in a transaction where those steps constitute an indirect path toward the transaction's endpoint and where those steps primarily were taken to get better tax results. Under the doctrine, tax results are determined by looking at the ultimate result of a series of transactions.

While the boundaries of the step transaction doctrine are subject to debate, courts have articulated three versions of the doctrine: (1) an end result test, (2) an interdependence test, and (3) a binding commitment test.[67] The broadest version is the end result test, which aggregates a series of transactions if the transactions are prearranged parts of a single transaction intended from the start to reach an ultimate result. Slightly less broad is the interdependence test, which groups together a series of transactions if the transactions are so interdependent that the legal relations created by one transaction would be pointless absent the other steps. The narrowest version is the binding commitment test, which joins together a series of transactions if, at the time the first step is taken, a binding legal commitment requires the later steps.[68] While the courts have disagreed over which particular test to apply in particular circumstances, such uncertainty has not prevented the courts from applying the doctrine liberally.[69]

3. Sham transaction doctrine and economic motivation test.

The sham transaction doctrine offers another route by which courts and the Service have attacked transactions lacking in economic substance or reality. Among the leading cases articulating the sham transaction doctrine are *Knetsch v. U.S.*[70] and *Goldstein v. Commissioner*.[71] In *Knetsch*, the Supreme Court held that a transaction—the purchase of ten 30-year deferred annuity bonds, financed by a down payment and funds borrowed from the issuer against the cash surrender value of the bonds—was "a sham," lacking any appreciable economic results, because "there

[64] *Braddock Land Co. v. Commissioner*, 75 T.C. 324, 329 (1980).

[65] *Higgins v. Smith*, 308 U.S. 473 (1940); *U.S. v. Morris & E.R. Co.*, 135 F.2d 711, 713 (2d Cir. 1943) ("[T]he Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favor[.]"), *cert. denied*, 320 U.S. 754 (1943).

[66] *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987). See M. Ginsburg & J. Levin, *Mergers, Acquisitions and Buyouts*, ¶608 (Oct. 1998 ed.).

[67] Ginsburg & Levin, *supra*, at ¶608.1.

[68] *Id*.

[69] See, e.g., *Jacobs Engineering Group v. U.S.* [97–1 USTC para. 50,340], No. CV 96–2662, 1997 U.S. Dist. LEXIS 3467 (C.D. Calif. March 6, 1997); *Associated Wholesale Grocers v. U.S.* [91–1 USTC para. 50,165], 927 F.2d 1517 (10th Cir. 1991); *Security Industrial Insurance Co. v. U.S.* [83–1 USTC para. 9320], 702 F.2d 1234 (5th Cir. 1983).

[70] 60–2 USTC para. 9785], 364 U.S. 361 (1960).

[71] [66–2 USTC para. 9561], 364 F.2D 734 (2d Circ. 1966), *cert. denied* 385 U.S. 1005 (1967)

was nothing of substance to be realized [by the taxpayer] beyond a tax deduction" (364 U.S. at 366). The court diverted its attention from the taxpayer's tax avoidance motive and focused instead on the taxpayer's failure to establish the presence of business purpose (the taxpayer's subjective state of mind) or a justifying economic substance (an objective test) in the transaction.

The court based its conclusions on the fact that the taxpayer paid 3½ percent interest to the issuer of the bonds on its financing loan, while the investment grew at only 2½ percent per year. The net annual cash loss of one percent of the borrowed funds was incurred only to achieve a tax deduction for the interest paid, not for an "economic" profit. Although the taxpayer could have refinanced the loan if funds became available from another lender at a lower rate, he either failed to present evidence regarding the prospect of a decline in interest rates or failed to convince the trial judge that refinancing was a realistic option, and the Supreme Court implicitly assumed that it was not.[72]

In *Goldstein*, the taxpayer borrowed funds at 4 percent interest to purchase bonds paying 1½ percent interest and pledged the bonds as security for the loan. While the court held that the loans were not sham transactions because the indebtedness was valid, it nevertheless denied the interest deduction because the taxpayer did not enter into the transactions in order to derive any economic gain through appreciation in value of the bonds. Rather, the taxpayer borrowed the money solely in order to secure a large interest deduction which could be deducted from other income.

The Second Circuit's approach extended the sham transaction doctrine by adding an economic motivation requirement. As a result, the interest expense arising from even a bona fide indebtedness must meet an additional requirement of economic motivation to be deductible. Courts have denied interest deductions in transactions similar to those in *Goldstein* but without calling the transaction a sham—a term now reserved for a mere paper or "fake" transaction.[73] Under the economic motivation requirement, an interest deduction may be disallowed if no economic gain could be realized beyond a tax deduction.[74]

More recently, in *ACM*, *supra*, the Third Circuit applied the economic substance requirement and sham transaction doctrine to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court, in disallowing the losses, stressed the taxpayer's lack of any nontax business motive. However, the Third Circuit, affirming the Tax Court, focused on the transaction's lack of economic substance. The court held the transaction lacked economic substance because it involved "only a fleeting and economically inconsequential investment by the taxpayer." The Tax Court pursued a similar approach in *ASA Investerings*, *supra*, to deny a loss on the purchase and resale of private placement notes.

The above judicial doctrines and the numerous of cases they have generated have proven difficult to translate into clear, bright-line rules. That difficulty stems in part from the highly complicated facts in those cases, and in part from the uncertainty as to which facts the courts believed credible and which facts proved relevant to the outcome.[75] As a result of this uncertainty, the exact scope of those judicial doctrines is ill-defined and potentially extremely broad. This breadth, in effect, has acted as yet another arrow in the Service's quiver by exerting a strong in terrorem effect. While those judicial doctrines may not be impermeable, they represent a broad range of weapons available to the Service to attack tax avoidance. Moreover, those doctrines already impose high costs on legitimate business planning and inhibit efficiency.

C. Current anti-abuse rules in the Code.

The Code contains numerous provisions that give the Treasury Department and the Service broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income. An illustrative list of more than 70 provisions that explicitly grant Treasury and the Service such authority appears in Appendix B.

As demonstrated by this list, Treasury and the Service long have had powerful ammunition to challenge tax avoidance transactions. The Service has broad power to reallocate income, deductions, credits, or allowances between controlled taxpayers to prevent evasion of taxes or to clearly reflect income under section 482. While

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[72] B. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L. J. 693 (1978).

[73] *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 200 (1983).

[74] See, e.g., *Rothschild v. U.S.* [69–1 USTC para. 9224], 186 Ct.Cl. 709, 407 F.2d 404, 406 (1969).

[75] Bittker, *supra* n. 72.

much attention has been focused in recent years on the application of section 482 in the international context, section 482 also applies broadly in purely domestic situations. The Service also has the authority to disregard a taxpayer's method of accounting if it does not clearly reflect income under section 446(b).

In the partnership context, the Service has issued broad anti-abuse regulations under subchapter K.[76] Those rules allow the Service to disregard the existence of a partnership, to adjust a partnership's methods of accounting, to reallocate items of income, gain, loss, deduction, or credit, or to otherwise adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the Service believes the results are inconsistent with the intent of the partnership tax rules.

The Service also has issued a series of far-reaching anti-abuse rules under its legislative grant of regulatory authority in the consolidated return area. For example, under Treas. Reg. Sec. 1.1502–20, a parent corporation is severely limited in its ability to deduct any loss on the sale of a consolidated subsidiary's stock. The consolidated return investment basis adjustment rules also contain an anti-avoidance rule.[77] The rule provides that the Service may make adjustments "as necessary" if a person acts with "a principal purpose" of avoiding the requirements of the consolidated return rules. The consolidated return rules feature several other anti-abuse rules.[78]

D. IRS NOTICES.

The Service from time to time has issued IRS Notices stating its intention to issue subsequent regulations that would shut down certain transactions. Thus, a Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves—often a time-consuming process—that will provide more detailed rules concerning a particular transaction.

The Service has not been adverse to issuing such Notices. Recent examples include Notice 97–21, in which the Service addressed multiple-party financing transactions that used a special type of preferred stock; Notice 95–53, in which the Service addressed the tax consequences of "lease strip" or "stripping transactions" separating income from deductions; and Notices 94–46 and 94–93, addressing so-called "corporate inversion" transactions viewed as avoiding the 1986 Act's repeal of the *General Utilities* doctrine.[79] Appendix C includes an illustrative list of these types of IRS Notices issued in the past 10 years.

Moreover, the Service currently has the ability to prevent abusive transactions that occur before a Notice is issued. Section 7805(b) expressly gives the Service authority to issue regulations that have retroactive effect "to prevent abuse." Therefore, although many Notices have set the date of Notice issuance as the effective date for forthcoming regulations,[80] the Service can and has used its authority to announce regulations that would be effective for periods prior to the date the Notice was issued.[81] Alternatively, the Service in Notices has announced that it will rely on existing law to stop abusive transactions that have already occurred.[82]

E. LEGISLATIVE CHANGES.

To the extent that Treasury and the Service may lack rulemaking or administrative authority to challenge a particular transaction, the avenue remains open to seek enactment of legislation. In this regard, over the past 30 years dozens upon dozens of changes to the tax statute have been enacted to address perceived avoidance and abuses. Appendix D includes an illustrative list.

These legislative changes can be broken down into two general categories. The first includes legislative changes that respond specifically to a transaction deemed to be abusive or otherwise outside the intended scope of the tax laws. For example,

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[76] Treas. Reg. 1.701–2.

[77] Treas. Reg. § 1.1502–32(e).

[78] E.g., Treas. Reg. § 1.1502–13(h) (anti-avoidance rules with respect to the intercompany transaction provisions) and Treas. Reg. § 1.1502–17(c) (anti-avoidance rules with respect to the consolidated return accounting methods).

[79] The *General Utilities* doctrine generally provided for nonrecognition of gain or loss on a corporation's distribution of property to its shareholders with respect to their stock. See, *General Utils. & Operating Co. v. Helvering*, 296 US 200 (1935). The *General Utilities* doctrine was repealed in 1986 out of concern that the doctrine tended to undermine the application of the corporate-level income tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985).

[80] See, e.g., Notice 95–53, 1995–2 CB 334, and Notice 89–37, 1989–1 CB 679.

[81] See, e.g., Notice 97–21, 1997–1 CB 407.

[82] Notice 96–39, I.R.B. 1996–32.

bills (H.R. 435, S. 262) now pending before the 106th Congress would address "basis-shifting" transactions involving transfers of assets subject to liabilities under section 357(c). The proposal first was advanced by the Administration, in its FY 1999 budget submission, and subsequently was introduced as legislation by House Ways and Means Committee Chairman Bill Archer. Other recent examples of specific legislative actions to address potential or identified abuses would include a provision addressing liquidating REIT and RIC transactions enacted in the 1998[83] and a provision imposing a holding period requirement for claiming foreign tax credits with respect to dividends under section 901(k), enacted as part of the Taxpayer Relief Act of 1997.[84] The Administration's FY 2000 budget submission includes a number of proposals addressing specific types of transactions. As stated above, whether or not the tax policy rationales given by Treasury for these proposals are persuasive, as a procedural matter it is proper that these proposals now will undergo Congressional scrutiny.

These targeted legislative changes often have immediate, or even retroactive, application. For example, the section 357(c) proposal currently before Congress would be effective for transfers on or after October 19, 1998—the date that Chairman Archer introduced the proposal in the form of legislation. Chairman Archer took this action, in part, to stop these transactions earlier than would have been the case under effective date originally proposed by the Administration (the date of enactment). Moreover, in some cases, Congress includes language in the legislative history stating that "no inference" is intended regarding the tax treatment under prior law of the transaction addressed in the legislation. This language is intended, in part, to preclude any interpretation that otherwise might arise that enactment of the provision necessarily means that the transaction in question was sanctioned by prior law.

It should be noted that Congress and the Administration do not always agree on the appropriateness of specific legislative proposals advanced by Treasury that purport to address areas of perceived abuse. In fact, more than 40 revenue-raising proposals proposed by the Administration in its last three budget proposals (for FY 1997, FY 1998, and FY 1999) have been rejected by the Congress. Appendix E provides a list of these Administration proposals.

The second category of legislation includes more general changes to the ground rules under which corporate tax executives and the Service operate. These "operative rules" include, for example, modifications to the penalty structure applicable to tax shelters, tax understatements, and negligence, as well as new reporting requirements. Operative changes generally are considered by Congress far less frequently than the changes targeting specific abuses, and for good reason. These changes typically are intended to influence taxpayer behavior or increase Service audit tools where Congress sees an identifiable need for change. Changes then usually are given time to take full effect so that their impact can be measured to determine if they have achieved their desired result or if additional action might be necessary.

In 1997, as discussed above, Congress enacted changes broadening the definition of "tax shelter" transactions subject to penalties and requiring that transactions be reported to the Service when undertaken under a confidentiality arrangement. Congress concluded that this change would "improve compliance by discouraging taxpayers from entering into questionable transactions."[85] Because these changes have not yet taken effect (a result of Treasury's failure to issue regulations—to this date—that would activate the changes), Congress has not yet had an opportunity to gauge their impact.

Before the 1997 Act changes to the tax shelter rules, Congress had last enacted operative changes in this area of the tax law as part of the Uruguay Round Agreement Act of 1994, under which Congress modified the substantial understatement penalty for corporations participating in tax shelters.

The corporate tax shelter proposals advanced in the Administration's FY 2000 budget that are within the scope of this testimony would represent the most far-reaching operative changes ever enacted by Congress. Moreover, not only would they take effect before Congress has had a chance to evaluate the impact of its last round of operative changes, they would take effect even before the last round of changes has entered into force. Such a change is unprecedented in the annals of tax policymaking in this area.

In some instances, these newly proposed operative provisions would allow Treasury to challenge the very same types of transactions that have been targeted by spe-

[83] P.L. 105–277, section 3001.

[84] P.L. 105–34, section 1053.

[85] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* 222 (1997).

cific legislative changes sought by the Administration but rejected by Congress. Given the apparent divergence of views between Congress and the Administration on the appropriateness of specific tax legislative changes, it would be odd for the Congress at this time to hand Treasury and the Service unprecedented authority to dictate tax policy.

V. RESPONSIBILITIES AND BURDENS OF CORPORATE TAXPAYERS

A. RESPONSIBILITIES OF CORPORATE TAX EXECUTIVES.

The chief tax executive of a typical U.S. corporation has many responsibilities and burdens in the tax preparation, collection, and enforcement process. This individual must oversee and implement systems to collect a variety of federal income, wage withholding, and excise taxes. He or she must be able to analyze and implement an incredibly complex, ever-changing and, in many instances, arcane and outdated tax system made up of an intricate jumble of statutes, case law, regulations, rulings, and administrative procedural requirements.

Notwithstanding this veritable maze of complicated and many times inconsistent rules that collectively comprises our tax law, this individual has a further responsibility to the management and shareholders of the corporation. He or she must understand management's business decisions and planning objectives, assess the tax law consequences of business activities, and counsel management about the tax consequences of various possible decisions. In the course of assisting management in the formation of business decisions, the corporate tax executive must assess the state of a very complex and uncertain tax law and must be able to provide advice to management on appropriate ways to minimize tax liabilities.

Once those business decisions are made, he or she must implement them by supervising the formation of applicable entities, creating necessary systems for capturing tax-related information as it is generated from the business, and implementing necessary procedures for the calculation and remittance of taxes, information returns, and other documentation and materials necessary for compliance under the federal tax laws. Finally, the chief tax executive must be able to explain the appropriateness of tax positions taken by the company, as well as its tax collection, remittance, and reporting systems, to the Service upon examination.[86]

In short, a chief tax executive must be able to understand an incredibly complex set of federal tax rules, advise and assist management in the formation of decisions that result in proper minimization of taxes, implement tax collection and reporting system for those decisions, and explain the appropriateness of those decisions and systems in examination discussions with the Service.

B. TAX EXECUTIVE'S VITAL ROLE TO THE U.S. GOVERNMENT AS TAX ADMINISTRATOR.

Collectively, the chief tax executives of U.S. corporations play a very significant role in the collection and remittance of federal taxes. They shoulder the ultimate responsibility within their corporations for adequate systems to collect and remit corporate income taxes, federal wage withholding taxes, and an array of excise taxes. The corporate tax department is *the* private administrator of the U.S. income tax.

It is estimated that corporate income tax collections in FY 1998 were $189 billion. Individual income tax payments withheld by corporations and remitted to the Treasury were approximately $375 billion, or more than 40 percent of gross individual income tax collected. Payroll tax withheld for Social Security and unemployment insurance by corporations amounted to approximately $315 billion, or 61 percent of payroll taxes collected. Corporations accounted for the bulk of the $76 billion in excise and customs duties collected. In sum, of the $1.7 trillion in tax revenue collected by the Federal government in FY 1998, corporations either remitted directly or withheld and remitted more than 50 percent, vastly reducing the compliance burden on the Service and individuals.

In addition to direct tax payments and withholding, corporations also provide information returns to the Service on payments made to employees, contractors, suppliers, and investors. In 1998 more than one billion information returns were filed by U.S. businesses with the Service, accounting for income and transactions exceed-

[86] Large corporations are enrolled in the Service's coordinated examination program (CEP) and generally are under continuous audit by the Service to assure the appropriateness of tax return positions taken by those corporations.

ing $18 trillion.[87] In addition to providing this information to the Service, U.S. businesses also provide this information (as required) to affected taxpayers to assist them in meeting their tax filing obligations.[88] Corporations provided the vast majority of these information returns.

Without the help of corporate tax departments, collection and other administrative costs to the government would be significantly higher and rates of compliance significantly lower.

C. CHALLENGES AND BURDENS PRESENTED BY TAX LAW COMPLEXITY.

1. In general: burdens and costs.

The extreme complexity of the U.S. tax law is especially burdensome for corporate taxpayers. Confronted by a jumble of statutes, case law, and administrative rulings and notices, the tax executives of a corporation often must take into account a veritable library full of materials in determining the appropriate tax treatment of a specific transaction.

There are 3,052 pages of statutory language in the Internal Revenue Code (1994 ed.), and 11,368 pages of Treasury regulations contained in Title 26 of the Code of Federal Regulations. (Additionally, the Treasury Department has a substantial backlog of unfinished guidance projects designed to assist in the clarification of these complex rules (see list contained in Appendix F)). Further, there are thousands of pages of Revenue Rulings, Revenue Procedures, Notices, private letter rulings, technical advice memoranda, field service memoranda, and other administrative materials potentially relevant to the determination of the appropriate tax treatment of a particular transaction. More than 9,300 Tax Court cases have been decided since 1949, and thousands of additional court precedents exist in tax cases decided by the U.S. District Courts, the U.S. Courts of Appeals, the Court of Claims, and the U.S. Supreme Court. Further, there are about 50 international tax treaties and various other agreements that may be applicable to the U.S. tax treatment of specific international transactions.

Research has found that the compliance costs of the corporate income tax resulting from this complexity are significant. In 1992, Professor Joel Slemrod of the University of Michigan surveyed firms in the Fortune 500 and found an average compliance cost of $2.11 million, or more than $1 billion for the entire Fortune 500.[89] The cost for a sample of 1,329 large firms was more than $2 billion in the aggregate. About 70 percent of this cost is estimated to be attributable to the federal tax system, with the remaining 30 percent attributable to State and local income taxes. These estimates exclude the costs of complying with payroll, property, excise, withholding, and other taxes.

The firms surveyed by Professor Slemrod generally were among the largest 5,000 U.S. companies. He found that compliance costs are largest for the biggest firms, but relative to firm payroll, assets, or sales, they are proportionately larger for the smaller firms in this sample.

The specific sources of the complexity of the U.S. tax law are many. In Professor Slemrod's survey, respondents were asked to identify the aspects of the tax law that were most responsible for the cost of compliance. Three aspects cited most often were the depreciation rules, the alternative minimum tax, and the uniform capitalization rules.

The depreciation and uniform capitalization rules are examples of the complexity created through differences between financial statement income and taxable income. The U.S. tax accounting rules deviate significantly from financial accounting rules, requiring substantial modifications to financial statement income in order to com-

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[87] Not all dollar amounts reported on information returns are included in income. For example, the 1099-B reports the gross proceeds from the sale of certain investments. Only the gain from the sale of these investments is included in gross income.

[88] These information returns include Form W–2 (Wage and Tax Statement), Form W–2G (Certain Gambling Winnings), Form 1099–DIV (Dividends and Distributions), Form 1099–INT (Interest Income), Form 1099–MISC (Miscellaneous Income), Form 1099–OID (Original Issue Discount), Form 1099–R (Distributions from Pensions, Annuities, etc.), Form 1099–B (Proceeds from Broker and Barter exchange Transactions), Form 5498 (Individual Retirement Arrangement Contribution Information), Form 1099–A, Acquisition or Abandonment of Secured Property, Form 1098 (Mortgage Interest Statement), Form 1099–S (Proceeds from Real Estate Transactions), Form 1099C (relating to forgiven debt), Form 5498–MSA (Medical Savings Account Information), Form 1099–MSA (Distributions from Medical Savings Accounts), Form 1099–LTC (Long-Term Care and Accelerated Death Benefits), and Form 1098–E (Student Loan Interest Statement).

[89] Joel B. Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," Public Finance Quarterly, October 1996, v. 24, no. 4, pp. 411–438.

pute taxable income. This is in contrast to the tax laws of other countries, such as Japan, where there is much greater conformity between book income and taxable income. The depreciation and uniform capitalization rules also are examples of areas that have become more burdensome in recent years, with changes enacted with the Tax Reform Act of 1986 serving to increase the complexity.

The other area most frequently cited by the survey respondents, the alternative minimum tax, adds yet another layer of complexity. After making all the adjustments from financial statement income required in computing regular taxable income, the taxpayer then must compute alternative minimum taxable income. The computation of alternative minimum taxable income requires an extensive series of adjustments to regular taxable income, including adjustments to reflect different depreciation rules (which already is an area of particular complexity under the regular income tax). It is not just alternative minimum taxpayers that must make these computations; all these computations must be made in order for the taxpayer to determine *whether* it is subject to the alternative minimum tax. Moreover, like the depreciation and uniform capitalization rules, the alternative minimum tax rules were made significantly more burdensome by the 1986 Act changes.[90]

2. Complexity in international transactions.

For a corporate taxpayer with foreign operations or foreign-source income, compliance with complicated rules noted above is just the beginning. These taxpayers are subject to a set of detailed rules with respect to the U.S. tax treatment of the taxpayer's foreign income. The United States taxes domestic corporations on their worldwide income. The international tax rules—both specific provisions and the body of rules in general—were another area of complexity cited by many of the respondents in Professor Slemrod's study.

U.S. taxpayers must calculate separately domestic-source and foreign-source income. To do so, they must allocate and apportion all expenses between domestic and foreign sources. In addition, the foreign tax credit rules apply separately to nine different categories or "baskets" of income.[91] Accordingly, U.S. taxpayers must calculate foreign-and domestic-source income—and allocate and apportion expenses to such income—separately for *each* basket. All these computations then must be done again under the alternative minimum tax rules.

U.S. taxpayers with foreign subsidiaries must report currently for U.S. tax purposes certain types of the foreign subsidiaries' income, even though that income is not distributed currently to the U.S. parent. In addition to the complicated rules that must be applied to determine the portion of the subsidiaries' income that is subject to current inclusion, U.S. tax accounting rules must be applied to determine the foreign subsidiaries' earnings and profits (which may require a translation first from local GAAP to U.S. GAAP and then from U.S. GAAP to U.S. tax accounting principles). The U.S. parent also must include with its U.S. tax return detailed information with respect to each foreign subsidiary.[92]

Of course, a U.S. taxpayer with foreign operations is subject not just to the U.S. tax rules but also to the tax rules of the country where the operations are located. For many U.S. multinational corporations, this means that the corporation will be responsible for compliance with the tax laws of numerous jurisdictions around the world. The results of each operation must be reported both for local tax purposes and for U.S. tax purposes, under rules that may reflect significant differences in terms of both characterization and timing. Layered on top of the local and U.S. tax rules are the provisions of an applicable income tax treaty between the two countries. The treaty provisions have the effect of modifying the impact of the internal rules of the particular countries. Application of the treaty requires understanding of the provisions of the treaty itself as well as any understandings or protocols associated with the treaty and the Treasury Department's detailed technical explanation of the treaty.

One specific example of the tax law complexities and commensurate responsibilities confronting a chief tax executive of a large U.S.-based multinational corporation is the planning and analysis necessary to implement an internal restructuring

[90] Respondents in Professor Slemrod's survey, *supra* n. 89, cited alternative minimum tax, uniform capitalization, and depreciation as among the 1986 Act provisions that most contributed to increasing the complexity of the U.S. tax system.

[91] The rules currently create additional income baskets for dividends from *each* foreign corporation in which the taxpayer owns a 10-percent voting interest but which is not a controlled foreign corporation. Although the Taxpayer Relief Act of 1997 included a provision eliminating these additional baskets, that provision will not be effective until 2003. (A Treasury budget proposal would accelerate this elimination.)

[92] Provisions enacted with the 1997 Act require similar reporting with respect to foreign partnerships in which the U.S. taxpayer has an interest.

of a line of business within the company. An internal restructuring of a particular business unit within a corporate structure may be desired by management to build efficiencies in the overall business, to prepare for an acquisition of a related line of business, or to prepare for a disposition of a line of business. In any event, the chief tax executive must research and analyze dozens of discrete tax issues in the implementation of this management decision, including the choice of appropriate entity (e.g., partnership, corporation, or single member LLC), place of organization (involving State tax or international tax issues), possible carryover of tax attributes (e.g., accounting methods and periods, earnings and profits, and capital and net operating losses), consideration of new tax elections, and consideration of the application of complex consolidated tax return regulations. Moreover, if the internal restructuring impacts any foreign operations of the company, the chief tax executive also must research and analyze all the foreign tax implications of the restructuring. The foreign tax treatment of the internal restructuring—and of any alternative approaches to accomplishing the business objectives—may be very different than the U.S. tax treatment of the same transaction or transactions.

D. Responsibility of the corporate tax executive to shareholders.

Corporate executives have a fiduciary duty to increase the value of a corporation for the benefit of its shareholders. Reducing a corporation's overall tax liability can increase the value of a corporation's stock. There are, however, several reasons that corporate tax executives will avoid undertaking aggressive, tax-motivated transactions.

Corporate tax executives must meet professional and company-imposed ethical standards that preclude taking unsupported, negligent, or fraudulent tax positions.[93] Also, incurring significant tax penalties has the effect of reducing shareholder value. If the reversal of a tax position and the cost of the penalties are not properly provided for in a company's financial statements, a restatement of those financial statements may be required, which could be devastating to a corporation's stock value. Financial accounting standards require that all material tax positions which are contingent as to their outcome must be specifically disclosed to shareholders. Also, with most corporations focused on preserving and enhancing their brands, corporate tax executives are careful not to recommend a transaction to management that later might be reported unfavorably in the national press as being improper.

VI. RESPONSIBILITIES OF TAX ADVISERS

This section of the testimony sets out views of the role played by accounting firms in providing assistance to corporations on tax issues.

A. Reasons why corporate tax executives need assistance.

As discussed previously, the chief tax executive of a corporation has many duties and burdens in analyzing federal, State, and foreign tax consequences of business decisions, implementing collection and remittance systems for a variety of federal and State income and excise taxes, and reviewing tax return positions with Service and State tax personnel upon examination of tax return positions. These duties require accurate analysis of very complex federal statutes, regulations, rulings, and administrative procedures, which in turn requires keeping current on statutory, regulatory, and administrative developments as well as a burgeoning body of case law. Also, today's chief tax executive must have an intimate knowledge of information technology systems designed to capture necessary tax data from business operations and provide essential compliance and remittance functions.

Only in the smallest of corporate business contexts can one person be charged with all these disparate responsibilities. In large corporations, even with the assistance of a significant number of knowledgeable staff, the chief tax executive must turn to outside advisers for professional assistance for a variety of consulting and compliance needs.

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[93] Corporate tax executives are governed by professional conduct standards promulgated by the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) if the corporate tax executive is a member of either of these two professions. In addition, a corporate tax executive is governed by "Circular 230" (31 C.F.R. Part 10), which provides rules of conduct for practicing before the Service. Additionally, the existing penalty provisions (discussed above) that apply to the corporation act as a significant deterrent to a tax exeuctive's recommending a transaction that might trigger penalties.

B. ASSISTING TAX EXECUTIVES FULFILL DUTIES AS TAX ADMINISTRATORS.

The accounting profession provides invaluable assistance to the chief tax executive in his or her role as a tax administrator charged with the collection and remittance of a variety of federal taxes. Accounting firms provide assistance in designing and implementing information technology systems to track data for preparation of the company's tax return, as well as systems for collecting, remitting, and providing appropriate information returns and schedules for employee withholding and other taxes.[94] In many instances, the chief tax executive of a corporation utilizes a mix of systems provided by accounting firms and other service providers which are then implemented by corporate personnel; in other instances, compliance and reporting functions are "outsourced" in whole or in part to accounting firms by the corporation.

To the extent accounting firms assist in the tax administrator role of the chief tax executive of a corporation, the accounting firm is subject to the commensurate duties to provide accurate data collection, retrieval, remittance, and reporting systems. Given the sophisticated information technology systems necessary in large corporations to comply with the complex tax laws, it is fair to say that the accounting profession's involvement substantially enhances corporate tax compliance and augments Service tax administration.

C. ASSISTANCE IN ADDRESSING COMPLEX ANALYTICAL ISSUES.

The ever-changing tax law, with its lack of precision and clarity, requires a chief tax executive to confront analytical difficulties in assessing the tax consequences of business activities. Many of these business activities are common to many corporations and industries. For example, considerable uncertainty exists currently as to the appropriate tax classification of a variety of expenditures made by corporations in upgrading technological business systems.

The accounting profession can bring invaluable assistance to corporate tax executives faced with having to analyze the tax consequences of an array of business activities where the appropriate tax analysis is not clear from the rules and procedures, and where the time invested by the corporation in developing an independent analysis of the taxation of a business activity cannot be justified given the broad experience of professional advisors in analyzing similar situations for other corporations.[95] In such cases, the accounting firm providing analytical assistance is subject to standards of professional responsibility.[96]

Also, decisions made to promote the objectives of a corporation—for example, to expand a U.S.-based business abroad or to divest a portion of the business deemed no longer part of the "focus" of the corporation—can result in literally hundreds of substantive tax issues that must be researched and assessed in order to provide the chief tax executive a degree of certainty that certain tax positions are appropriate. Only the largest corporations have tax departments of sufficient size and personnel specialization to afford the company the ability to perform this necessary analysis internally. In many cases, the accounting profession provides essential assistance to corporations in fulfilling these analytical responsibilities.

D. ASSISTANCE IN PRUDENT TAX PLANNING.

Corporate executives have fiduciary duties to shareholders to consider the tax results of various potential business decisions and appropriately to minimize the tax impact of business operations. Accordingly, in working closely with management, the chief tax executive of a corporation must offer proactive assistance in structuring business decisions to meet planning objectives while prudently minimizing tax consequences.

As one simple example, a company may feel that the product manufactured by a particular subsidiary no longer promotes the business objectives of the corporation. The value of the subsidiary exceeds the tax basis in its assets, and if the subsidiary were sold a large capital gain would be realized and recognized by the corporation. A prudent tax professional would recommend to management that, as part

[94] Payroll service firms and other service providers also can provide corporations with assistance in tax administrative functions.

[95] Law firms provide legal advice with respect to tax analytical and planning issues. These comments are focused on the role of accounting firms.

[96] The AICPA's "Statements on Responsibilities in Tax Practice" (1988 Rev.) consist of advisory opinions that provide conduct guidelines to practicing CPAs. The statements (cited as "SRTPs") cover a number of common situations that the practicing CPA deals with on a regular basis. Most importantly, SRTP No. 1 provides guidelines for taking tax return positions.

of its overall business decision making process regarding the subsidiary, a tax-free reorganization be considered, possibly a spin-off of the subsidiary to the corporation's shareholders for a valid business purpose (the fit and focus of the remaining group) while preserving the most value of the subsidiary to those shareholders. The chief tax executive of a corporation would be remiss if he or she did not focus management on the tax implications of this potential decision and actively explore alternative business structures to fulfill management objectives.[97]

Accounting firms provide professional consulting services to the chief tax executive as various planning ideas are reviewed and analyzed to determine the most advantageous method for implementing business objectives from a tax standpoint. Such planning assistance is necessary for most corporations that do not have sufficient internal resources to review and understand the vast number of issues involved in assessing the best structure or optimal course of action necessary to fulfill corporate objectives in the most tax-efficient manner.

In some areas of business planning, many corporations may share similar objectives. For example, many corporations across various industries recently have been investigating mergers to obtain essential business economies of scale. Accordingly, accounting firms have developed specialty expertise in many complex and sophisticated issues relating to the taxation of merger and acquisition activity. These firms thus can advise corporate executives in an efficient manner on merger and acquisition issues without forcing the executives to "reinvent the wheel" by devoting a significant amount of time and resources to obtaining solutions that accounting firms have more readily available because of specialization and experience. Also, to the extent that the contemplated transaction would result in potential foreign tax law consequences, the fact that large accounting firms have personnel or affiliated firms in multiple world-wide locations means that they can provide efficient services to the chief corporate executive of a U.S.-based multinational corporation.

VII. CONCLUSION

We respectfully urge Congress to reject the Administration's broad proposals relating to "corporate tax shelters." As discussed above, the proposals could affect many legitimate business transactions, further hamstringing corporate tax executives seeking to navigate the maze of federal, State, and international tax laws applicable to corporations. Congress already has provided Treasury with ample administrative tools—some of which Treasury has not yet self-activated—to address situations of perceived abuse. There is no demonstrated need at this time to expand these tools, particularly in such a way that would give the Service's revenue agents nearly carte blanche authority to "deny tax benefits." Instead, where specific areas of concern are identified, Congress and the Treasury should work together—as they have done in the past—to enact legislation targeting such cases.

Chairman ARCHER. Thank you, Mr. Kies. Let me reiterate that your printed statement will be inserted in the record, without objection, in its entirety.

Mr. Weinberger, if you will identify yourself, you may proceed.

STATEMENT OF MARK A. WEINBERGER, PRINCIPAL, WASHINGTON COUNSEL, P.C.

Mr. WEINBERGER. Thank you, Mr. Chairman. My name is Mark Weinberger. I am a partner with Washington Counsel, a law firm here in Washington.

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[97] It is pertinent to note that the tax law allows taxpayers to select among a variety of structures and forms to accomplish business objectives, some of those decisions resulting in lower ultimate tax liability than other decisions. This deliberation and choice for taxpayers should be considered a normal part of the income tax system, and should not be inhibited or penalized. For example, the staff of the Joint Committee on Taxation does not consider choosing doing business in partnership form (subject to a single level of tax on operations) instead of doing business in corporate form (subject to taxation at the corporate and shareholder levels) a tax expenditure, or exception to normal tax rules. See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 1999–2003* (JCS–7–98), December 14, 1998, p. 6.

I appreciate this opportunity to testify today on the administration's revenue proposals, specifically those relating to corporate tax shelters. I understand and appreciate the concern that motivated the administration to put forward the corporate tax shelter proposals. To the extent taxpayers are entering into transactions that are not sanctioned under applicable law, those taxpayers extract a cost that is borne by all taxpayers, both individuals and corporations, and may undermine the foundation of our voluntary tax system.

However, in my opinion, the administration's corporate tax shelter proposals are unnecessary, and certainly premature, exceedingly vague and far-reaching, and appear to create an unprecedented transfer of power to the executive branch, and specifically IRS revenue agents.

I would like to make seven short observations.

First, the rhetorical and anecdotal press accounts that have surfaced surrounding tax shelters suggests the corporate tax base is rapidly eroding and is in imminent danger of imploding. While the perception of a problem is in itself a problem, and therefore requires attention, the evidence simply does not suggest the entire corporate tax base is at risk.

Corporate tax receipts have risen for the last 9 years, and are projected to increase in the coming years. Moreover, the administration's own estimates of the savings its proposals are projected to achieve are modest, less than 0.2 percent of the total projected tax receipts over the next 5 years.

Second, the administration's proposals are sweeping separately and collectively. The subjective nature of the definitions will create significant uncertainty and lead to widely disparate treatment of similarly situated taxpayers. They impose new taxes on seemingly legitimate and ordinary business transactions, something I am sure this Committee is not intent on doing.

Third, the proposal represents an unprecedented delegation of power to the executive branch and IRS revenue agents to override laws enacted by Congress, and to institute new laws by administrative fiat. The Super section 269 proposal would give the executive branch authority to disregard its own regulations and the laws duly enacted by this Congress when the Secretary does not like the results. The rules would clearly diminish congressional prerogative. An interesting question would be, how many of the revenue raisers previously rejected by this Committee or accepted, but in alternative form, would have been unnecessary to even submit to Congress for consideration if these rules were in place?

Fourth, while the expanded authority would technically vest with the Secretary, it will be exercised by the IRS agents all around the country. Such power can be abused by agents and used to threaten taxpayers to settle unrelated tax issues that arise in annual audits. This is a one-way street that can only be used to the taxpayers' detriment. It is contrary to the steps this Committee and Congress took last year in enacting the IRS Restructuring and Reform Act.

Fifth, Congress must act judiciously. Once such power is transferred to the executive branch, it would be very hard for Congress to reclaim it. Any attempt by Congress to reverse such action would be scored as a revenue loser under current scoring conventions. Some of the issues raised by the alternative minimum tax discussion earlier would also exist here.

Sixth, the executive branch already has considerable tools at its disposal to address tax-abusive transactions. The IRS has been aggressive and often successful in attacking transactions through exam and litigation, and has stepped up the issuances of notices and regulations to address what it perceives as abuses. In addition, this Committee addressed legislatively situations brought to its attention by Treasury when it deemed proper.

Importantly, as recently as in 1997, this Committee and ultimately Congress, passed a law expanding the definition of what qualifies as a tax shelter for purposes of reporting requirements and the substantial understatement penalty provisions. Treasury, in asking for this proposal, explained that the provision would help the IRS get information about deals in a timely manner so that it could audit and take appropriate action. Treasury has not even implemented this provision yet, and the administration is asking for more power, broader authority, and more punitive weapons.

Seventh, if the current rules are inadequate, the Committee should review them and their effect before adding another layer of penalties and rules on top of the existing system. This only creates more complexity and potential pitfalls for taxpayers. It goes in the exact opposite direction of the IRS Restructuring and Reform bill's mandated study to review penalty and interest rules with an eye toward simplifying penalty and interest administration and reducing taxpayer burden.

In conclusion, Mr. Chairman, as I said at the outset, I understand and appreciate the concern that motivated the administration to put forward the proposals being discussed. I am eager to work with the Committee Members and staff, along with Treasury, to address the many imperfections in our tax system. With all due respect, I think a more appropriate approach to deal with the problems the administration raised would be to more thoroughly evaluate the scope of the problem, and analyze the effectiveness of the tools the IRS already has in its exposure, including those that have been enacted but have not yet been utilized. Only when the necessary tools are proved wanting should the Committee provide additional tools. Even then, such provisions should be narrowly crafted.

I will be happy to answer any questions the Committee has at the appropriate time. Thank you.

[The prepared statement follows:]

Statement of Mark A. Weinberger, Principal, Washington Counsel, P.C.

MR. CHAIRMAN and Members of the Committee, I appreciate this opportunity to testify today on certain of the Administration's revenue raising proposals addressing so-called "corporate tax shelters." While my written testimony discusses the "tax shelter proposals," I will be happy to answer questions regarding other provisions in the President's FY2000 Budget that I am familier with. I am appearing today on behalf of a number of companies who share your objective of a tax system that is fair, easy to understand and administer, and does not undermine the ability of business to create jobs at home and compete in our global economy. However, the testimony I am submitting today represents my own views and may not reflect the view of each company.

The unifying theme of the companies I represent is a desire to work with Congress, and the Treasury Department, to ensure that we have a fair and administrable tax system from both the taxpayer's and the government's perspective. To the extent that taxpayers are entering into transactions that are not sanctioned under the applicable law, those taxpayers extract a cost that is born by all other taxpayers—both individuals and corporations, and may undermine the foundation of our voluntary tax system. We are concerned, however, that several of the current corporate tax shelter proposals in the President's FY2000 budget are unnecessary and certainly premature, exceedingly vague and far reaching, and appear to create an unprecedented transfer of power to the Executive Branch and specifically IRS revenue agents. As a result, we believe they can cause problems in policy and practice. We would like to offer our support, however, in working with your staff, and with the Administration, in addressing the many imperfections that plague our complex and burdensome tax system.

It is difficult to address in detail the Administration's corporate tax shelter proposals because they have not yet been drafted, the Administration has not yet released statutory language nor its promised "White Paper," and because the proposals are a radical departure from historic norms of income taxation. Nonetheless, as you review the Administration's proposals, we urge you to consider two significant points:

- First, any legislative action should be commensurate with the problem, if and when articulated.
- Second, any legislative action should not create unintended adverse consequences that outweigh any expected benefits.

I. Overview of the Administration's Proposals

The Administration has proposed several general provisions aimed at curbing corporate tax shelters, as well as a number of specific provisions intended to attack the results of particular transactions. Following is a brief overview of the general provisions.

A. The Administration Has Proposed Broad Definitions of Corporate Tax Shelters

The Administration's Budget suggests that "corporate tax shelters" may take several forms but often share common characteristics, including (i) marketing by promoters to multiple corporate taxpayers, (ii) arranging transactions between corporate taxpayers and persons not subject to U.S. tax, (iii) high transaction costs, (iv) contingent or refundable fees, (v) unwind clauses, (vi) financial accounting treatment that is significantly more favorable than the corresponding tax treatment, and (vii) property or transactions unrelated to the corporate taxpayer's core business. These factors are incorporated into four broad definitions included in the Administration's proposals that potentially could extend to a broad sweep of corporate transactions not ordinarily considered inappropriate.[1]

1. A *corporate tax shelter* would be defined as any entity, plan or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.
2. A *tax benefit* would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the congressional purpose for such provision and the interaction of such provision with other provisions of the Code).
3. A *tax avoidance transaction* would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (*i.e.*, tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income (emphasis added).
4. A *tax indifferent party* would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. For purposes of this definition, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.

[1] Even the Treasury Department has acknowledged that its proposed definitions may unintentionally target "good transactions." Bureau of National Affairs, *Daily Tax Report* G–3 (March 5, 1999).

B. Summary Description of the Administration's Proposals

1. Modify Substantial Understatement Penalty for Corporate Tax Shelters.—This proposal would increase the substantial understatement penalty applicable to corporate taxpayers for any item attributable to a "corporate tax shelter" from 20 percent to 40 percent of the tax associated with the understatement. In addition, the reasonable cause exception would be eliminated for any item attributable to a corporate tax shelter. The penalty could be reduced to 20 percent if the corporate taxpayer (i) discloses the transaction to the IRS and files copies of the transaction documents within 30 days of the transaction's closing, (ii) files a statement with its tax return verifying that such disclosure has been made and (iii) provides adequate disclosure on its tax returns as to the book/tax differences resulting from the corporate tax shelter item for the taxable years in which the tax shelter transaction applies.

2. Deny Certain Tax Benefits to Persons Avoiding Income Tax as a Result of Tax Avoidance Transactions.—This "Super Section 269" proposal would expand the scope of the government's existing authority to disallow certain benefits when certain acquisitions are undertaken for the principal purpose of evading or avoiding federal income tax by securing the benefit of a deduction, credit or allowance. As proposed, Section 269 would be expanded to allow the government to disallow any deduction, credit, exclusion or other allowance obtained in a "tax avoidance transaction."[2]

3. Deny Deductions for Certain Tax Advice and Impose an Excise Tax on Certain Fees Received.—This proposal would deny a deduction to a corporate taxpayer that participates in a "tax avoidance transaction" for fees paid or incurred in connection with the purchase and implementation of "corporate tax shelters" and the rendering of tax advice related to "corporate tax shelters." In addition, the proposal would impose a 25 percent excise tax on the receipt of such fees.

4. Impose Excise Tax on Certain Rescission Provisions and Provisions Guaranteeing Tax Benefits.—This proposal would impose a 25 percent excise tax on the maximum payment under a "tax benefit protection arrangement" entered into in connection with the purchase of a "corporate tax shelter" by a corporate taxpayer. The Administration would define a "tax benefit protection arrangement" to include a rescission clause, guarantee of tax benefits arrangement or any other arrangement that has the same economic effect (*e.g.*, insurance purchased with respect to the transaction).

5. Preclude Taxpayers from Taking Tax Positions Inconsistent with the Form of Their Transactions.—This proposal would prohibit a corporate taxpayer from taking any position (on any return or refund claim) that the federal income tax treatment of a transaction is different from that dictated by its form if a "tax indifferent party" has a direct or indirect interest in the transaction. This rule would not apply if (i) the taxpayer discloses the inconsistent position on a timely filed original federal income tax return for the taxable year in which the transaction is entered into, (ii) if reporting the substance of the transaction more clearly reflects the income of the taxpayer (but only to the extent allowed by regulations), or (iii) to certain transactions identified in regulations, such as publicly available securities lending and sale-repurchase transactions.

6. Tax Income from Corporate Tax Shelters Involving Tax-Indifferent Parties.—This proposal would provide that any income allocable to a "tax indifferent party" with respect to a "corporate tax shelter" is taxable to such party, regardless of any statutory, regulatory or treaty exclusion or exception. Moreover, all other taxpayers involved in the "corporate tax shelter" would be jointly and severally liable for the tax.

II. The First Objective Should Be to Assess Causes and the Severity of "The Problem" and Ensure Any Remedies Do Not Risk Causing More Harm than Good.

The rhetoric, and anecdotal press accounts, that have surfaced surrounding "tax shelters" suggest that the corporate tax base is rapidly eroding and in imminent danger of imploding. In his testimony before this Committee last month, Treasury Secretary Rubin stated that the targeted transactions "not only erode the corporate tax base, they also breed disrespect for the tax system both by people who participate in the corporate tax shelter market and by others who perceive corporate tax shelter users as paying less than their fair share of tax."[3] While the perception of

[2] All Section references are to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

[3] Hearing on the President's Fiscal Year 2000 Budget Before the House Committee on Ways and Means, 106 Cong. (1999) (statement by the Honorable Robert E. Rubin, Secretary U.S. Department of the Treasury).

a problem is in itself a problem and therefore, requires attention, the data we have reviewed simply does not support the claims that the entire corporate tax base is at risk.[4]

These statistics indicate that, despite the Administration's belief that certain transactions are contributing to the erosion of the corporate tax base, corporate taxpayers in the United States have paid more money to the federal government for each of the past nine years, and that the percentage of corporate income tax receipts as compared to both total federal receipts and gross domestic product has remained steady over the past decade.[5] Indeed, the Administration's own revenue estimates suggest that the scope of the problem is limited.[6]

One of the reasons cited by government agencies and officials for surpluses higher than expected over the past couple years, and in the future, is a stronger than expected economy resulting in higher than expected profits and in turn taxable revenue. U.S. businesses have become more efficient in their business operations and have been able to raise capital to effectively compete in the global market place.

Corporate Income Tax Receipts

Year	Corporate Income Tax Receipts	Total Receipts	Percent of Total	Percent of GDP
FY1989	$103,291,000	$991,190,000	10.4%	1.9%
FY1990	$93,507,000	$1,031,969,000	9.1%	1.6%
FY1991	$98,086,000	$1,055,041,000	9.3%	1.7%
FY1992	$100,270,000	$1,091,279,000	9.2%	1.6%
FY1993	$117,520,000	$1,154,401,000	10.2%	1.8%
FY1994	$140,385,000	$1,258,627,000	11.2%	2.1%
FY1995	$157,004,000	$1,351,830,000	11.6%	2.2%
FY1996	$171,824,000	$1,453,062,000	11.8%	2.3%
FY1997	$182,293,000	$1,579,292,000	11.5%	2.3%
FY1998	$188,677,000	$1,721,798,000	11.0%	2.2%

However, the Congressional Budget Office (CBO) notes that "corporate profits are beginning to be squeezed by higher labor costs and the inability of firms to raise prices in the face of strong opposition from home and abroad."[7] CBO also notes that corporate profits will decline primarily because of a projected increase in GDP share devoted to depreciation.[8] CBO predicts that some decline in corporate profits from recent levels is "inevitable" because of the sensitivity of corporate profits to business-cycle fluctuations.[9] In an era of projected budget surpluses, the size of which is due in part to increased corporate profits and taxes thereon, the Congress should think seriously before enacting proposals that would restrict the ability of corporate taxpayers to operate efficiently and respond to changing market conditions.[10] This is especially true when CBO is predicting increased pressures on future corporate profits.

Accordingly, the Committee should not let anecdotal evidence and targeted press accounts attacking various transactions lead to enacting hastily contrived legislation that remains vague and over reaching. The threshold for enacting legislation in the area remains high. In my view, tax shelters do not threaten the entire corporate tax base. Accordingly, responses to the problem, when appropriately articulated, should not be left vague and far reaching in a way that threatens the ability of U.S.

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[4] The following table is compiled from data set forth in Office of Management and Budget, Historical Tables, Budget of the United States Government, Fiscal Year 2000 (February 1999).

[5] Moreover, the Administration's estimates for the next five years indicate that this trend will continue, with corporate income taxes as a percentage of gross domestic product remaining at approximately 2.1 percent for each of those years and annual corporate payments continuing to trend up.

[6] The Administration estimates that the six proposals outlined above would increase revenues by $1.76 billion over five years—less than 0.2% of total projected corporate tax receipts over that period. Of this amount, $830 million relates to the proposal to tax income attributable to tax indifferent parties.

[7] CBO, Economic and Budget Outlook, Fiscal Year 2000–2009, January 1999, p. 24.

[8] Ibid, p. 27.

[9] Ibid.

[10] This comment refers to the potential stifling effect the tax shelter proposals may have on legitimate corporate transactions as well as several other proposals in the President's FY2000 budget aimed at making it more difficult for taxpayers to efficiently restructure and raise capital (*e.g.*, tax increase proposals listed in sections entitled "Financial Products" and "Corporate Provisions" in the *General Explanation of the Administration's Revenue Proposals*, (February 1999)).

businesses to operate efficiently and, ultimately, corporate profits and the Federal revenues they generate.

III. Treasury Has Several Existing Tools to Combat its Perceived Problem Which Should Be Evaluated Before Piling on New Ones.

Much of the rhetoric relating to the Administration's proposals suggests that the government needs the tools proposed therein because it is not aware of transactions and tax planning arrangements which it might deem inappropriate. That is why the Administration proposed numerous specific provisions to attack transactions that it does not like, plus the general provisions in case there are others which they have not yet found.

The IRS has several old and some new tools at its disposal to deal with the issue. Before enacting new proposals, existing proposals should be carefully and thoroughly reviewed. If they do not work or are inadequate perhaps they should be repealed and replaced with new ones. However, adding another layer of penalties and rules to overlay existing ones merely creates more complexity and potential pitfalls for taxpayers. It goes in the exact opposite direction of the intent of the study authorized as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act) which requires a study reviewing the "administration and implementation by the Internal Revenue Service of interest and penalty provisions .... and legislative or administrative recommendations....to simplify penalty or interest administration and to reduce taxpayer burden."[11]

As recently as 1997, this Committee and ultimately the Congress, passed a law that expanded the definition of what qualifies as a "tax shelter" for purposes of registering such transactions with the IRS.[12] When Treasury proposed the registration in February 1997, it explained that the provision would help get the IRS useful information about corporate deals at an early stage to help identify transactions to audit and then take appropriate action—presumably seeking additional legislative and regulatory action when necessary.[13]

The filing requirement becomes effective when Treasury Regulations are prescribed. To date, such regulations have not been issued. Putting aside the many issues to be resolved once Treasury releases its view of the expansive new definition of corporate tax shelters, there appears to have been little effort to assess the effectiveness of existing programs,[14] as modified in 1997, before compounding it with this myriad of new proposals.

The new expansive definition of tax shelters was also carried over to Section 6662, the substantial understatement penalty provision. Accordingly, the increased exposure to the penalty, as a result of the 1997 changes, is virtually brand new and has not been assessed.[15] In this case, unlike the registration requirement discussed above, there is no requirement that the arrangement involve a corporation, a confidentiality agreement or minimum promoter fees. As a result, it is worth noting, that under current law a corporate taxpayer can fully disclose a position on a tax return and can have substantial authority for such position but still be subject to penalty if the transaction is considered a tax shelter. The only way to avoid a penalty is to establish reasonable cause which, by regulation, Treasury has already circumscribed so that for example, a taxpayer's reasonable belief that it is more likely

[11] *See*, Joint Committee on Taxation Press Release, 98–2 (December 21, 1998).

[12] *See* Section 1028 of the Taxpayer Relief Act of 1997(adding Section 6111(d) to the Internal Revenue Code).

[13] *See* the U.S. Treasury Department's General Explanations of the Administration's Revenue Proposals, at 81 (February 1997). According to Treasury: Many corporate tax shelters are not registered with the IRS. Requiring registration of corporate tax shelters would result in the IRS receiving useful information at an early date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better informed judgments regarding the audit of corporate tax returns and to monitor whether legislation or administrative action is necessary regarding the type of transactions being registered.

[14] Section 6111 was added to the Code in the Tax Reform Act of 1984. In 1989, the Commissioner's task force *Report on Civil Tax Penalties* concluded that "[v]irtually no empirical data exists" about the Section 6111 penalty (VI–22 and n. 29 (1989)). See also, *New Tax Shelter Penalties Target Most Tax Planning*, Mark Ely and Evelyn Elgin, Tax Notes (December 8, 1997).

[15] As suggested by the staff of the Joint Committee on Taxation in their description of the Administration's revenue proposals, "it may be premature to propose new measures to deal with corporate tax shelters when provisions have already been enacted that are intended to that, but where there has been no opportunity to evaluate the effectiveness of those already-enacted provisions because they have not yet become effective because of the lack of the required guidance." Staff of the Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal year 2000 Budget Proposal*, JCS–1–99 at 165 (Feb. 22, 1999) (hereinafter the "JCT Report").

than not to prevail may not be sufficient.[16] The Administration would remove even the reasonable cause escape hatch, in addition to doubling the penalty rate in certain circumstances.

Many have argued that the success of the 1997 changes to the substantial understatement penalty rules will turn on how artfully the term tax shelter is defined by the Treasury Department and enforced by IRS agents. There is great concern in the business community that the expanded definition will provide a strong incentive for revenue agents to set up penalties as bargaining chips in negotiations. Before considering giving these agents more authority and larger weapons, I believe it is important to evaluate the effect of these most recent changes. It seems premature, if not unnecessary, to be exploring the Administration's 16 new proposals even before the most recent changes take effect.

Moreover, as a practical matter, when it does identify what it perceives as "abuses," the IRS has been aggressive (and often successful) in attacking those transactions through examination and litigation. Significant cases that the government has won in recent years include: *Ford Motor Co. v. Commissioner*, 102 T.C. 87 (1994), *aff'd* 71 F.3d 209 (6th Cir. 1995) (Tax Court limited a current deduction for a settlement payment, stating that tax treatment claimed by the taxpayer would have enabled it to profit from its tort liability); *Jacobs Engineering Group, Inc. v. United States*, 97–1 USTC 87,755 (CCH ¶50,340) (C.D. Cal. 1997) (applying Section 956 to a transaction despite the fact that a literal reading of the regulations would not have subjected the taxpayer to that provision); *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), *aff'd* 157 F.3d 231 (3d Cir. 1998) (not respecting a partnership's purchase and subsequent sale of notes, stating that the transaction lacked economic substance); *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998) (applying an intent test to determine that a foreign participant in a partnership was a lender, rather than a partner, for federal income tax purposes); *but see*, *Wolff v. Commissioner*, 148 F.3d 186 (2nd Cir. 1998) (reversing the Tax Court's denial of an ordinary loss in connection with the extinguishment of an unregulated futures contract, stating that the fact that the taxpayer selected the cancellation method (as opposed to closing the contract by offset) does not justify imposition of the legal "substance over form" fiction).

Likewise, the Administration regularly addresses what it perceives as "abuses" through notices and regulations. In recent years, the Treasury Department has promulgated a number of regulations and other rules intended to stop certain so called "inappropriate" tax planning. These include the partnership anti-abuse regulations,[17] the anti-conduit financing regulations,[18] the temporary regulations targeting the improper use of tax treaties by hybrid entities [19] and the recently proposed regulations targeting fast-pay stock arrangements.[20] Moreover, on a number of occasions in recent years, the Treasury Department has issued notices to target specific tax planning techniques, typically announcing its intention to issue regulations addressing such techniques, effective as of the date of the notice. Examples of this approach include notices attacking inversion transactions,[21] fast-pay stock arrangements,[22] transactions involving the acquisition or generation of foreign tax credits [23] and transactions involving foreign hybrid entities.[24]

Under the present system, when the Treasury Department identifies a perceived "abusive" transaction, whether through rulemaking or by way of a specific legislative proposal, this Committee and its counterpart in the Senate have not hesitated to enact legislation to curb transactions that they perceive as inappropriate. For example, two years ago, Mr. Chairman, you announced a proposal targeting certain *Morris Trust* transactions, and, working with the Senate and the Treasury Department, enacted a solution through the tax legislative process. Similarly, last May you introduced legislation to eliminate certain tax benefits involving the liquidation of a regulated investment company or real estate investment trust, and, working with the Senate and the Treasury Department, enacted a solution effective as of the date of your announcement. The solutions that Congress provides to the perceived problems identified by the Treasury Department are not always the solutions proposed by the Administration, but that is merely a reflection of our system of government,

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[16] See Sections 6662(d)(2)(c)(ii) and 6664(c) establishing the reasonable cause exception. See Treas. Reg. Section 1.664-(4)(e)(3) discussing the limitation.
[17] Treas. Reg. § 1.701–2.
[18] Treas. Reg. § 1.881–3; Prop. Treas. Reg. § 1.7701(l)–2.
[19] Temp. Treas. Reg. § 1.894–1T.
[20] Prop. Treas. Reg. § 1.7701(l)–3.
[21] Notice 94–46, 1994–1 C.B. 356.
[22] Notice 97–21, 1997–1 C.B. 407.
[23] Notice 98–5, 1998–3 I.R.B. 49.
[24] Notice 98–11, 1998–6 I.R.B. 13.

which separates the executive and legislative functions in independent branches. Thus, the *Morris Trust* legislation imposes a tax at the corporate level, whereas the Treasury Department's original proposal would have imposed a tax at both the corporate and shareholder levels.

We are not suggesting that there are no transactions which generate unanticipated and inappropriate tax consequences. To the contrary, these results are the inevitable outcome of a tax system that is too complex and burdensome. We also recognize the obvious—taxpayers and their advisors move quickly to take advantage of perceived tax planning opportunities. However, wholesale new laws with vague and punitive components do not further a cooperative environment for taxpayers and the government. We believe there is a great difference between disclosure requirements and punitive tax increases. The concepts should be separated.

On that note, disclosure of appropriate information to the IRS is an important element of successful enforcement. This Committee approved enhanced disclosure of tax shelters in the 1997 IRS Restructuring and Reform Act. This is on top of existing disclosure requirements. In this regard, we note that corporate taxpayers generally are required to reconcile their book and taxable income on the face of the corporate income tax return.[25] As indicated above, the Administration has suggested that many "corporate tax shelters" involve differences between the financial accounting treatment and the federal income taxation of a transaction. To the extent that this is correct, corporate taxpayers already are required to show this difference to the IRS. Every book-tax difference is subject to a fairly full set of IDRs, which probably exceeds the information the IRS will get in disclosure. Because the vast majority of large corporate taxpayers participate in the large case examination program, in which revenue agents work at the taxpayer's headquarters in order to conduct continual audits of the taxpayer's returns, and because these agents have ready access to the taxpayer's corporate tax department, the IRS already has the information it needs to identify potential "corporate tax shelters." If this information proves inadequate, perhaps modification of existing disclosure laws is in order.

IV. The Administration Is Seeking an Unprecedented and Inappropriate Delegation of Power

To the extent that this Committee determines that legislative action is required in this area, such action should be commensurate with the problem. Moreover, the Committee should balance carefully the expected benefit of any legislative proposal with the likely adverse consequences of enacting such a proposal. As discussed below, the Administration's proposals are not commensurate with the problem, and, in fact, represent an unprecedented delegation of legislative authority to the Executive Branch and IRS revenue agents.

The breadth of the operative definitions for the proposals, outlined above, indicates that the Treasury Department is casting a very wide net with its proposals. The subjective nature of the definitions would create significant uncertainty as to their applicability in many circumstances, as well as lead to the potential for widely disparate treatment of similarly situated taxpayers. Of particular concern is the proposed definition of a "tax avoidance transaction," which requires a comparison of the "reasonably expected pre-tax profit" and the "reasonably expected net tax benefits," as well as a determination of whether a transaction involves the "improper elimination or significant reduction of tax on economic income."[26] The proposed definition of a "tax benefit" suffers from similar flaws, in that it requires an evaluation of whether a tax benefit is "clearly contemplated" by a particular Code provision "taking into account the congressional purpose" for the provision, as well as the "interaction of such provision with other provisions of the Code." The proposed definition of a "tax indifferent party," on the other hand, would ignore congressional purpose, allowing the IRS to tax Native American tribal organizations or tax-exempt organizations, despite the fact that Congress has provided those categories of taxpayers with exemptions from tax. Moreover, the latter definition would add another kind of uncertainty for taxpayers, in that parties to a transaction could wind up subject to deficiencies and penalties for the simple reason that they did not know

[25] Internal Revenue Service Form 1120, Schedule M–1.

[26] It should be noted that this definition would encompass a number of the Administration's other legislative proposals, including some that the Congress has rejected out of hand. For example, more than three years ago the Treasury Department proposed legislation that would impose an average cost basis regime for securities. This proposal, which the Congress has rejected repeatedly, would end the current practice of allowing taxpayers to determine which particular stock to sell, when the only factor in that decision today is the amount of gain that will be subject to tax as a result. Undoubtedly, the taxpayer's decision in such cases is tax motivated, has no impact on expected pre-tax profits, and could lead to a "reduction of tax on economic income."

whether another party to the same transaction had expiring loss or credit carryforwards. Quite simply, these sweeping definitions are a recipe for attacks on legitimate tax planning, Executive Branch nullification of laws duly enacted by Congress, and endless litigation and confrontation between taxpayers and agents.

What is particularly troubling about the unprecedented delegation of authority to the Executive Branch and revenue agents are the proposals, such as the "Super Section 269" proposal, which would allow the Executive Branch and revenue agents to reverse substantive results otherwise required under particular Code provisions based on their determination that a transaction involves the improper elimination or reduction of tax on economic income or otherwise comes within the proposed definition of a "tax avoidance transaction." In the real world, corporate taxpayers regularly enter into transactions or arrange their affairs in such a manner as to reduce their income taxes. The capital markets tend to reward corporations that can increase financial income without increasing taxable income.

Notwithstanding these realities the "Super Section 269" proposal, as described by the Administration, would apply to an endless number of routine transactions and tax planning activities that no reasonable observer would consider "abusive." As Judge Learned Hand observed over sixty years ago:

> A transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[27]

This basic principle would be reversed in one grand gesture if the Congress enacts "Super Section 269." Under that provision, taxpayers could be penalized for merely arranging their transactions in such a manner as to obtain the lowest amount of tax required under the Code.

To date, the breathtaking scope of this particular proposal has been defended on two grounds. On occasion, it has been claimed that it is narrower than current law. This seems odd—if true, however, there is no reason to enact it. The other defense is the classic "trust me" claim—we're from the government, we can tell the good from the bad, and we won't abuse our power. While perhaps well intentioned, policy initiatives of the Treasury and National Office of the IRS are sometimes ill-advised, and often implemented by IRS agents in ways unanticipated and unintended. Whether it is because the laws are so complex or the agents use them as a means to extract other concession, such broad authority is dangerous. The proposal provides too much authority to the Executive Branch and revenue agents and will be difficult to undo once such power is transferred.

In order to fathom the Administration's intended scope of the "Super Section 269" proposal, we urge you to pose the following questions to the Treasury Department:

- How many of the specific proposals presented by the Administration would be redundant if the Congress enacts the "Super Section 269" proposal?
- How many of the dozens of revenue raising provisions enacted by the Congress in the past twenty years addressing transactions characterized as loopholes, tax shelters and the like would be redundant if the Congress enacts the "Super Section 269" proposal?
- How many of the dozens of revenue raising provisions presented by this Administration (as well as those presented by the two prior Administrations) but that have been rejected by the Congress would effectively become law if the Congress enacts the "Super Section 269" proposal?

We respectfully suggest that you reject the Administration's proposals dealing with corporate tax shelters until they provide you with convincing and satisfactory answers to these and similar questions.

As a substantive matter, the "Super Section 269" proposal would give the Executive Branch authority to disregard its own regulations, and the laws duly enacted by the Congress, when "the Secretary" does not like the results.[28] The problem with this is that it would allow "the Secretary" to determine both (i) whether there is a problem, and (ii) how to address the perceived problem. Once "the Secretary" changed the law under this authority, any attempt by the Congress to reverse such an action as bad policy would be scored as a revenue loser under the current scoring conventions in the Federal Budget process. Congress would find itself in the odd po-

[27] *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934), *aff'd* 293 U.S. 465 (1935).

[28] For example, the proposal to tax income allocable to "tax indifferent parties" specifically states that it would tax such income "regardless of any statutory, regulatory or treaty exclusion or exception."

sition of having extreme difficulty overturning Treasury's rules. This is an extraordinary proposal, and one that we urge you to reject.

Moreover, no one should be fooled by the delegations to "the Secretary." The real world implication of the Administration's proposals is that, although the proposals undoubtedly would authorize "the Secretary" to disallow deductions, impose excise taxes or otherwise implement the proposals, at the end of the day it is the IRS revenue agents sitting in the corporate offices of corporate taxpayers who will be deciding what is "clearly contemplated" by a particular Code provision.

This new power for revenue agents requested by the Administration could be abused, such as by being used to threaten taxpayers to settle unrelated tax issues that may arise during an audit.[29] For example, it is not difficult to imagine a revenue agent setting up assessments based on an alleged "corporate tax shelter," including the proposed 40 percent substantial understatement penalty, in an attempt to obtain concessions from the taxpayer on other issues. Although the Internal Revenue Service is in the process of remaking itself in response to Congress's goal in last year's IRS Restructuring and Reform Act, we urge you to think carefully before delegating such significant power to revenue agents.

The penalty suggested by the Administration for corporate taxpayers that engage in transactions that the Administration does not like is unprecedented. The overlapping proposals would have the effect of taxing corporate income not twice, as is the norm under our current system, but three or more times. For example, a corporate taxpayer could (i) lose expected tax benefits under the "Super Section 269" proposal, (ii) lose deductions for fees paid in a transaction, (iii) pay an excise tax on fees in a transaction, (iv) pay an excise tax on a "tax benefit arrangement" entered into in connection with the transaction, (v) pay taxes attributable to a "tax indifferent party" involved in the transaction, and (vi) pay a forty percent (40%) penalty on top of the underlying tax. The cumulative effect in some cases could be treble or quadruple taxation, or worse. Never before has the Congress sought to tax the same transaction so many times. What is even more striking is that, as noted above, such onerous penalties could be imposed on taxpayers who comply with the specific Code provisions enacted by Congress and regulations issued by the Treasury Department. That is, the taxpayer loses even if it follows the rules.

V. The Administration's Proposals Violate Fundamental Notions of Neutrality and Fair Play

In many ways, what is most striking about the Administration's proposals is their blatant disregard for fundamental notions of neutrality and fair play. This disregard is evident in four respects.

First, the Administration fails to acknowledge that many of the "uneconomic" tax consequences of which it complains are the direct result of its own "uneconomic" rules—rules that the Administration crafted for the purpose of over-taxing taxpayers. Perhaps the single best way for the Administration to curb transactions with results that it finds troublesome would be for the Administration to write rules that are even-handed and neutral in their application. For example, when the IRS successfully asserted in litigation and other guidance that Section 357(c) applies to a liability even when the transferring taxpayer remains liable for it (thereby leading to an assessment that substantially exceeds its "economic income,"), other taxpayers reached the reasonable conclusion that this rule of law would apply in all circumstances, not just when it helped the IRS and hurt taxpayers. Section 357(c) applies when the liability is secured by another asset that the transferor retains. Mr. Chairman, your bill to address such transactions would not be necessary if the IRS had adopted a more even-handed approach in the first instance.[30]

Second, the Administration fails to acknowledge that many of the "problems" of which it complains are the by-product of the way we tax enterprise income and our system of double taxation. Unfortunately, it appears that the Administration has chosen not to work through these difficult structural issues. It is as though they have thrown up their hands in surrender and said, "we give up on principled solutions; just let us do what we want based on what we think is fair."

Third, the Administration's proposals are a one way street. In some respects, the "Super Section 269" proposal is a request for equitable powers—let the IRS do "right" when the law as written has consequences "not clearly contemplated" by Congress. Setting aside the uncertainties created by this concept, and setting aside the wisdom of delegating such power to the IRS, one question remains. What about all of those circumstances where the law as written has unanticipated consequences

[29] *See* JCT Report, *supra* note 14, at 166.
[30] *See* H.R. 18, 106th Cong., 1st Sess. (1999).

that are adverse to taxpayers? We suggest you ask whether the Administration would support an "equitable relief" provision that runs both ways. Would the Administration support a provision that would entitle taxpayers to the "right" answer when a literal application of the law would give rise to unfair results—unless, of course, those unfair results were "clearly contemplated" by Congress? Mechanical rules seem to be binding on taxpayers, why not the IRS? Our fear is the proposals put forth by the Administration would have the unintended effect of eliminating any incentive for the Administration to write fair and even-handed rules.[31]

Fourth, the Administration has offered few proposals to remedy the many defects of our system that adversely affect corporate taxpayers. There are no comprehensive proposals to simplify the tax law. There are no proposals to remedy the mess created by *INDOPCO, Inc. v. Commissioner*.[32] There are no proposals to ameliorate the over-taxation of economic income and the repeated taxation of that income. There are no proposals to enhance the competitiveness of American companies in the global economy.

VI. CONCLUSION

As I stated at the outset, Mr. Chairman, we understand and appreciate the concern that motivated the Administration to put forward the proposals that the Committee is discussing today. We are eager to work with you and your colleagues, and with the Administration, to address the many imperfections in our tax system—flaws that disadvantage taxpayers, as well as flaws that harm the federal fisc. With all due respect, however, it is clear that the path suggested by the Administration is a radical and unwarranted departure from long-standing norms—a departure that would not do justice to taxpayers and the tax system.

A more appropriate approach to the problems suggested by the Administration is to evaluate (i) the true scope of the perceived problem, (ii) the ability of the IRS to identify imperfections in our tax system through the tools it already has, and (iii) the ability of the government to address the problems that it does identify, either through the rulemaking process or in the courts. Only when the Treasury Department and the IRS do not have the necessary tools to address the problems that they identify, or when the Treasury Department identifies problems that it cannot address through its existing regulatory authority, should this Committee provide additional tools and delegations of authority to the IRS.

Chairman ARCHER. Thank you, Mr. Weinberger.

Mr. Wamberg, you are next. If you will identify yourself for the record, you may proceed.

STATEMENT OF W.T. WAMBERG, CHAIRMAN OF THE BOARD, CLARK/BARDES, DALLAS, TEXAS

Mr. WAMBERG. Good afternoon. My name is Tom Wamberg. I am the chairman of the board of Clark/Bardes, a publicly traded company, headquartered in Dallas, Texas.

Our company designs insurance-based programs for financing employee benefit plans. Our clients include a broad range of businesses. They use these insurance products as assets to offset the liabilities of these employee benefit plans and to supplement and secure plans for senior executives.

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[31] For example, if Congress enacted the "Super Section 269" proposal, it is quite possible that the IRS could use that authority to attack transactions without trying to develop fair rules to address perceived problems. To illustrate, the Administration's proposal to prevent the importation of "built-in losses" would apply equally to gains and losses. Thus, when a foreign individual with appreciated property becomes a resident of the United States, the basis of that property would be marked to market, so that the individual would be taxable upon a sale of the property only to the extent of any gain attributable to the period after immigration. If the "Super Section 269" proposal is enacted, but the "built-in loss importation" proposal is not, then the IRS would be able to target built-in loss importation transactions, but at the same time would continue to tax a lifetime of earnings not attributable to an individual's residence in the United States.

[32] 503 U.S. 79 (1992).

I am here today to express Clark/Bardes' strong opposition to the administration's proposal that would increase taxes on companies that purchase insurance covering the lives of their employees. This same proposal was included in the administration's budget last year, but was wisely not enacted. I would like to express our appreciation to the Members of the this Committee who last year raised strong objections to the administration's proposed tax increase on insurance products. I am pleased to know that this opposition remains strong this year.

There are many reasons why Congress again, should not adopt the administration's proposal. The first is, employer-owned life insurance has long been used by businesses to fund a variety of business needs, including the need to finance their growing retiree health and benefit obligations. The rules under ERISA generally make it impossible for businesses to set aside funds to secure these benefits. Investment in life insurance, which does not run afoul of the ERISA rules, allows employers to meet their future benefit obligations.

Second, the tax policy concern that caused Congress to target leverage COLI in 1996 do not support the administration's proposal before us today. The current proposal would deny deductions for interest payments for any employer that happens to own life insurance, even though there is no direct link between the loan interest and the life insurance. Unlike the 1997 provision targeting the use of COLI with respect to nonemployees, this proposal attacks the very traditional uses of employer-owned life insurance.

Third, the administration's proposal represents yet another move by the administration to deny deductions for ordinary and necessary business expenses. If the proposals were enacted, companies would see expenses that they have deducted for years suddenly becoming nondeductible. For example, interest on a loan taken out 10 years ago to finance the creation or startup of a business. This is not a fair result.

Fourth, the administration's proposal is a thinly disguised attempt to tax the inside buildup on life insurance policies. Congress in the past has rejected proposals to change the tax treatment of inside buildup, and for good reason. The investment element inherent in permanent life insurance is a significant form of savings and long-term investment. I think you would agree that these are things that we should be encouraging and not taxing.

Finally, I would like to address the Treasury's attempt to brand employer-owned life insurance as a corporate tax shelter. This is a totally unwarranted characterization intended to build unthinking support for a failed proposal. A tax shelter is defined under the Code as any entity, plan, or arrangement, with respect to which tax avoidance or evasion is a significant purpose. It is difficult to see how traditional employer-owned life insurance programs could be viewed as meeting this definition.

For example, consider a situation where a company owning life insurance policies on the lives of its employees decided independently to borrow money totally unrelated to its life insurance program. Suppose they did that to construct a new manufacturing plant. The administration apparently believes that these separate actions can be collapsed down and viewed as a tax avoidance transaction. But it would be absurd to suggest that the company in this situation should be hit with stiff penalties that apply to true tax shelter transactions.

Under a broader view, a tax shelter might be thought of as an arrangement involving an unintended application of tax laws. It is impossible to argue that current employer-owned life insurance programs involve an unintended application of tax laws. In fact, few areas of the tax law have received such thorough scrutiny in recent years. Indeed, the use of employer-owned life insurance was expressly sanctioned in legislation in 1996 and 1997.

In closing, I would respectfully urge the Committee to reject the administration's misguided proposal to tax employer-owned life insurance as it did last year. The administration once again has failed to articulate a clear or compelling tax policy concern in respect to the current rules, and now has sought to couch employer-owned life insurance, altogether inappropriately, as a tax shelter. If enacted, the administration's proposal would represent a significant departure from current law and tax policy regarding the treatment of life insurance. It would have a significantly adverse impact on the ability of businesses to solve a variety of their needs, including the ability to finance meaningful health benefits to retired workers.

Thank you for your attention to this important matter.

[The prepared statement follows:]

Statement of W.T. Wamberg, Chairman of the Board, Clark/Bardes, Dallas, Texas

Clark/Bardes appreciates the opportunity to testify before the House Ways and Means Committee on the revenue-raising proposals included in the Administration's FY 2000 budget submission. Our testimony focuses specifically on a proposal that would increase taxes on companies purchasing insurance covering the lives of their employees.

Clark/Bardes is a publicly traded company headquartered in Dallas, Texas, and with offices around the country. We design, market, and administer insurance-based employee benefit financing programs. Our clients, which include a broad range of businesses, use insurance products as assets to offset the liabilities of employee benefits and to supplement and secure benefits for key executives.

Clark/Bardes strongly opposes the Administration's proposed tax increase on "corporate-owned life insurance" ("COLI"). The same proposal was floated by the Administration in its FY 1999 budget submission and wisely rejected by Congress. Perhaps in recognition of the fact that Congress last year found no coherent tax policy justification for such a change, the Administration this year has branded COLI as a "corporate tax shelter"—an egregious characterization intended to build visceral support for the proposal. Regardless of the Administration's rhetoric, the reasons for rejecting the COLI tax increase remain the same:

- Employer-owned life insurance remains an effective means for businesses to finance their growing retiree health and benefit obligations.
- The Administration's proposal shares none of the same tax policy concerns that drove Congressional action on COLI in 1996 and 1997 legislation.
- The current-law tax treatment of COLI was sanctioned explicitly by Congress in the 1996 and 1997 legislation.
- The Administration's proposal is a thinly disguised attempt to tax the "inside buildup" on insurance policies—i.e., a tax on a long-standing means of savings.
- The Administration's proposal represents yet another move by the Administration—along a slippery slope—to deny deductions for ordinary and necessary business expenses.

USE OF EMPLOYER-OWNED LIFE INSURANCE

Before turning to the Administration's proposal, Clark/Bardes believes it is important to provide background information on employer-owned life insurance—a business practice that does not appear to be well understood.

Many employers, large and small, provide health and other benefits to their retired employees. While ERISA rules generally make "dedicated" funding impossible, employers generally seek to establish a method of financing these obligations. This allows them not only to secure a source of funds for these payments but also to offset the impact of financial accounting rules that require employers to include the present value of the projected future retiree benefits in their annual financial statements.

Life insurance provides an effective means for businesses to finance their retiree benefits. Consultants, like Clark/Bardes, and life insurance companies work with employers to develop programs to enable the employers to predict retiree health benefit needs and match them with proceeds payable under the life insurance programs. A simplified example may help to illustrate:

> ABC Company guarantees its employees a generous health benefits package upon retirement. ABC Company is required to book a liability on its balance sheet for the eventual retirement of its employees, and needs to find ways to fund these obligations.
>
> ABC Company, working with consultants, takes out a series of life insurance policies on its employees. It pays level insurance premiums to the insurance carrier each year. The cash value on the life insurance policy accumulates on a tax-deferred basis. In the event that the contract is surrendered, ABC Company pays tax on any gain in the policy. In the event that employees die, ABC Company receives the death benefit and uses these funds to make benefits payments to its retired employees. Actuaries are able to match closely the amount of insurance necessary to fund ABC Company's liabilities.

The Administration's COLI proposal effectively would take away an employer's ability to finance retiree benefit programs using life insurance, and thus could force businesses to severely limit or discontinue these programs. It is ironic that the President's proposal would hamstring a legitimate means of funding post-retirement benefits when a major focus of Congress is to encourage private sector solutions to provide for the needs of our retirees.

THE ADMINISTRATION'S COLI PROPOSAL

The Administration's proposal to tax employer-owned life insurance should be viewed in light of the basic tax rules governing life insurance and interest expenses and recent changes made by Congress to the tax treatment of COLI.

Since 1913, amounts paid due to the death of an insured person have been excluded from Federal gross income. The present-law provision providing this exclusion is section 101 of the Internal Revenue Code of 1986, as amended (the "Code"). Amounts paid upon the surrender of a life insurance policy are excluded from taxable income to the extent of the aggregate amount of premiums or other consideration paid for the policy, pursuant to section 72(e) of the Code.

Section 163 of the Code generally allows deductions for interest paid on genuine indebtedness. However, sections 264(a)(2) and (a)(3) of the Code, enacted in 1964, prohibit deductions if the interest is paid pursuant to (i) a single premium life insurance contract, or (ii) a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract, unless the requirements of an applicable exception to the disallowance rule are satisfied. One of the exceptions to this interest disallowance provision, known as the "four-out-of-seven" rule, is satisfied if no part of four of the annual premiums due during a seven-year period (beginning with the date the first premium on the contract is paid) is paid by means of indebtedness.

The Tax Reform Act of 1986 (the "1986 Act") amended section 264 of the Code to limit generally deductions for interest paid or accrued on debt with respect to COLI policies covering the life of any officer, employee, or individual who is financially interested in the taxpayer. Specifically, it denied deductions for interest to the extent that borrowing levels on corporate-owned policies exceeded $50,000 of cash surrender value per insured officer, employee, or financially interested individual.

Congress in the Health Insurance Portability and Accountability Act of 1996 (the "1996 Act") eliminated deductions for interest paid on loans taken against the tax-free earnings under the life insurance contract. Specifically, the 1996 Act denied a deduction for interest paid or accrued on any indebtedness with respect to any life insurance policies covering an officer, employee, or financially interested individual of the policy owner. The 1996 Act provided a phase-out rule for indebtedness on existing COLI contracts, permitting continued interest deductions in declining percentages through 1998.

The 1996 Act provided an exception for certain COLI contracts. Specifically, the Act continued to allow deductions with respect to indebtedness on COLI covering up to 20 "key persons," defined generally as an officer or a 20-percent owner of the policy owner, subject to the $50,000 indebtedness limit, and further subject to a restriction that the rate of interest paid on the policies cannot exceed the Moody's Corporate Bond Yield Average-Monthly Corporates for each month interest is paid or accrued.

The Taxpayer Relief Act of 1997 (the "1997 Act") added section 264(f) to the Code. This provision generally disallows a deduction for the portion of a taxpayer's total interest expense that is allocated pro rata to the excess of the cash surrender value of the taxpayer's life insurance policies over the amounts of any loans with respect to the policies, effective for policies issued after June 8, 1997. However, section 264(f)(4) provides a broad exception for policies covering 20-percent owners, officers, directors, or employees of the owner of the policy. Thus, the interest deduction disallowance provision in the 1997 Act generally affected only COLI programs covering the lives of non-employees.

The COLI proposal in the Administration's FY 2000 budget, submitted on February 1, 1999, would extend the section 264(f) interest deduction disallowance to COLI programs covering the lives of employees.[1] The proposal therefore would apply a proportionate interest expense disallowance based on all COLI cash surrender values. The exact amount of the interest disallowance would depend on the ratio of the average cash values of the taxpayer's non-leveraged life insurance policies to the average adjusted bases of all other assets.

Lack of Tax Policy Justification

The Treasury Department, in its "Green Book" explanation of the revenue proposals in the Administration's FY 2000 budget, implies that the COLI measures taken by Congress in 1996 and 1997 were incomplete in accomplishing their intended goals. A closer inspection of the tax policy considerations that gave rise to the 1996 and 1997 changes would suggest otherwise.

The 1996 Act changes to the tax treatment of COLI focused on leveraged COLI transactions (i.e., transactions involving borrowings against the value of the life insurance policies), which it believed represented an inappropriate and unintended application of the tax rules. The "Blue Book" explanation of the 1996 Act, prepared by the staff of the Joint Committee on Taxation, states that leveraged COLI programs "could be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest."[2] The Blue Book further states:

> ... Congress felt that it is not appropriate to permit a deduction for interest that is funding the increase in value of an asset of which the taxpayer is the ultimate beneficiary as recipient of the proceeds upon the insured person's death. Interest paid by the taxpayer on a loan under a life insurance policy can be viewed as funding the inside buildup of the policy. The taxpayer is indirectly paying the interest to itself, through the increase in value of the policy of which the taxpayer is the beneficiary.[3]

The 1997 Act COLI provision grew out of concerns over plans by a particular taxpayer, Fannie Mae, to acquire corporate-owned life insurance on the lives of its mortgage holders. The 1997 Act changes, therefore, specifically targeted COLI programs developed with respect to non-employees. Both the House Ways and Means Committee Report and the Senate Finance Committee Report on the 1997 Act discuss an example involving a Fannie Mae-type fact pattern:

> If a mortgage lender can ... buy a cash value life insurance policy on the lives of mortgage borrowers, the lender may be able to deduct premiums or interest on debt with respect to such a contract, if no other deduction disallowance rule or principle of tax law applies to limit the deductions. The premiums or interest could be deductible even after the individual's mortgage loan is sold to another lender or to a mortgage pool. If the loan were sold to a second lender, the second lender might also be able to buy a cash

[1] By eliminating the section 264(f)(4) exception that currently exempts COLI programs covering the lives of employees, officers, and directors.

[2] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS–12–96), December 18, 1996, p. 363.

[3] Id, at 364.

value life insurance contract on the life of the borrower, and to deduct premiums or interest with respect to that contract.[4]

The COLI proposal in the Administration's FY 2000 budget lacks any similarly compelling tax policy justification. Unlike the 1996 Act provision targeting leveraged COLI programs, the Administration's proposal would apply where there is no link between loan interest and the COLI program.[5] And unlike the 1997 Act provision targeting the use of COLI with respect to non-employees, this proposal does not involve a newly conceived use of COLI.

In explaining the rationale underlying the proposal, the Treasury Department argues that the "inside buildup" on life insurance policies in COLI programs gives rise to "tax arbitrage benefits" for leveraged businesses.[6] Treasury argues that businesses use inside buildup on COLI policies to fund deductible interest payments, thus jumping to the conclusion that COLI considerations govern decisions regarding when businesses incur debt. This view is clearly erroneous. Businesses incur debt for business reasons (e.g. business expansion).

COLI IS NOT A "TAX SHELTER"

Clark/Bardes strongly objects to the Administration's characterization of COLI as a "corporate tax shelter." The penalty provisions of the Internal Revenue Code define a tax shelter as any entity, plan, or arrangement with respect to which tax avoidance or evasion is a significant purpose.[7] A separate proposal in the Administration's FY 2000 budget proposes a new definition of "corporate tax shelter" under section 6662 that would apply to "attempts to obtain a tax benefit" in a "tax avoidance transaction," defined as any transaction in which the reasonably expected pretax profit is insignificant relative to the reasonably expected net tax benefits.[8]

It is difficult to see how traditional COLI programs might reasonably be viewed as meeting any of these "tax shelter" definitions. As discussed above, the Administration's proposal would deny interest deductions on borrowings totally unrelated to COLI, for example, where a company owning life insurance policies on the lives of employees borrows money to construct a new manufacturing plant, or conversely, where a company that borrowed ten years ago to construct a plant now considers purchasing life insurance to help finance retiree benefits. The Administration apparently believes that these disparate actions can be collapsed and viewed as a tax-avoidance transaction or as an attempt to obtain tax benefits. It is difficult to see just what tax might be avoided in this situation or what tax benefit is being sought. Does Treasury seriously suggest that such a company should be hit with the stiff penalties that apply to tax shelter transactions? These are serious questions that do not appear to have thought through completely under the Treasury proposal.

Under a broader view, a "tax shelter" might be thought of as an arrangement involving an unintended application of the tax laws. It is impossible to argue that current COLI programs involve an unintended application of the tax laws. Few other areas of the tax law have received as thorough scrutiny in recent years. In the 1996 Act, Congress explicitly allowed COLI programs to continue in the future so long as they were not leveraged. In the 1997 Act, Congress carefully crafted a specific exception (designed to preserve longstanding use of unleveraged COLI) to the pro rata interest expense disallowance provisions for COLI programs covering employees. In other words, current COLI programs involve an intended application of the tax law.

ATTACK ON "INSIDE BUILDUP," SAVINGS

The Administration's COLI proposal, at its core, is not about "tax shelters" at all. Rather, it is a thinly veiled attack on the very heart of traditional permanent life insurance—that is, the "inside buildup" of credits (or cash value) within these policies that permits policyholders to pay level premiums over the lives of covered individuals. Although couched as a limitation on interest expense deductions, the proposal generally would have the same effect as a direct tax on inside buildup. Thus,

[4] H.R. Rep. No. 105–148, 105th Cong., 1st Sess. p. 501; S. Rep. No. 105–33, 105th Cong., 1st Sess., p. 186.

[5] Current law is quite specific that interest deductions resulting from both direct and indirect borrowing, i.e., using the policy as collateral, are disallowed. Sec. 264(a)(3).

[6] General Explanation of the Administration's Revenue Proposals, Department of the Treasury, February 1999, p.118.

[7] Section 6662(d)(2)(C)(iii)

[8] As a separate matter, Clark/Bardes believes the Administration's proposed new definition of "corporate tax shelter" is unnecessary, ill-advised, and could be broadly applied by IRS agents to attack many legitimate business transactions.

the proposal would reverse the fundamental tax treatment of level-premium life insurance that has been in place since 1913.

Congress in the past has rejected proposals to alter the tax treatment of inside buildup, and for good reason. The investment element inherent in permanent life insurance is a significant form of savings. Congress and the Administration in recent years have worked together in the opposite direction, considering new incentives for savings and long-term investment and removing obvious obstacles. It is odd that the Administration at this time would propose making it more difficult to save and invest through life insurance.

INAPPROPRIATE LIMITATION ON BUSINESS DEDUCTIONS

In some respects, Treasury's proposed denial of deductions for interest expenses for companies owning life insurance is not surprising. This proposal comes on the heels of other Clinton Administration proposals to chip away at deductions for expenses that long have been treated as ordinary and necessary costs of doing business. Another recent example is the provision in the Administration's FY 2000 budget to deny deductions for damages paid by companies to plaintiffs groups.

But the proposal is troubling nonetheless, as illustrated by a simple example. The XYX company in 1997 borrows funds to build a new manufacturing facility. The XYZ company in 1997 and 1998 is able to deduct interest paid on these borrowings. In 1999, the XYZ company, responding to concerns over mounting future retiree health obligations, purchases insurance on the lives of its employees. IRS agents tell the XYZ company that it has just entered into a "tax shelter." Suddenly, the XYZ company finds that a portion of the interest on the 1997 loan is no longer viewed by the government as an ordinary and necessary business expense. XYZ therefore is taxed, retroactively, on its 1997 borrowing.

The proposal becomes even more troubling when one considers the logical extensions of the Administration's rationale with respect to COLI. Might the IRS, using the same reasoning, someday deny home mortgage interest deductions for individuals who also own life insurance? Might the government deny deductions for medical expenses for individuals that enjoy tax-preferred accumulations of earnings in 401(k) accounts or IRAs?

CONCLUSION

Clark/Bardes respectfully urges the Committee on Ways and Means to reject the Administration's misguided COLI proposal, as it did in 1998. As discussed above, the Administration once again has failed to articulate a clear or compelling tax policy concern with respect to the current-law rules, and now has sought to couch COLI, altogether inappropriately, as a "tax shelter." If enacted, the Administration's proposal would represent a significant departure from current law and tax policy regarding the treatment of life insurance. It would have a significantly adverse impact on the ability of businesses to solve a variety of needs including the ability to finance meaningful retiree health benefits. It also would provide a disincentive for savings and long-term investment and would represent yet another attack on deductions for ordinary and necessary business expenses.

Clark/Bardes commends the 31 Members of the House Ways and Means Committee who have urged, in a February 4 letter, Chairman Bill Archer (R–TX) and Ranking Minority Member Charles Rangel (R–TX) to oppose enactment of the Administration's "unwarranted" revenue proposals targeting life insurance. We share your views.

Chairman ARCHER. Thank you, Mr. Wamberg.

Mr. Hernandez, if you will identify yourself for the record, you may proceed.

STATEMENT OF ROBERT HERNANDEZ, ALLIANCE OF TRACKING STOCK STAKEHOLDERS, AND VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, USX CORPORATION, PITTSBURGH, PENNSYLVANIA

Mr. HERNANDEZ. Thank you. I am Bob Hernandez, vice chairman and chief financial officer of USX Corp. I would also like to thank you, Mr. Chairman, for inviting USX to testify today. I would like to thank you on behalf of Vic Beghini, president of Marathon Oil, which as you know is headquartered in your district and the many Marathon employees that are there.

My testimony is on a subject that affects many communities, many jurisdictions, and many other corporations. My testimony will be on a little-known, but very serious proposal in the administration's fiscal year 2000 budget to tax the issuance of tracking stock. This proposal should be rejected by Congress and formally withdrawn by Treasury. It would impair companies' ability to invest in new business and technology development. It would harm existing stockholders. It would cost jobs. It would impose enormous costs, reduce business expansion, and although I am not a tax expert, there is no sound basis in tax theory or policy for taxing the issuance of parent company stock.

I would like to submit my statement for the record on behalf of the Alliance for Tracking Stock Stakeholders. This alliance is an informal group of companies that share concern for their continued ability to meet business objectives through the issuance of tracking stock.

Tracking stocks are separate classes of common stock issued by companies in more than one line of business. The holders of tracking stock receive dividends based on the earnings of a specified segment of the corporate issuer. My company, USX, for example, currently has two tracking stocks. One follows our steel business, the other tracks our energy business. The steel shareholders receive their dividends based on the performance of the steel segment. The energy stockholders get their dividends based on the performance of the energy side of the house.

Tracking stock developed in our case because stock markets prefer "pure play" securities, while debt markets prefer the more stable cash flows associated with companies in more than one business. This is an opportunity to appeal to both markets. The ability to issue these tracking stocks permitted my company to raise more than $2.5 billion of equity that was vitally needed to revitalize our businesses, (and $3.5 billion of lower cost debt) since we adopted it in 1991.

Fifteen companies have issued 37 separate tracking stocks since 1991. Specific reasons the other companies have issued tracking stock vary, but include: growth of startup businesses as a source of equity capital, stock-based employee incentive programs, maintaining consolidated credit as we did to enhance borrowing arrangements, enhancing stock market value, and so forth.

I hope you can see that tracking stock is motivated by compelling business needs. It has unlocked shareholder value and opened up new capital markets to many diversified companies.

The administration's proposed tax legislation would have a chilling effect on those markets. It could force companies to recapitalize up to $400 billion of equity securities. Provisions actually could adversely impact tax revenues. They would destroy the operating financial and administrative synergies that are found in these combined entities. Therefore, the revenue raising estimates are not realistic, and actually could be negative.

As chief financial officer of USX, and a member of our board since 1991, I have been involved in every aspect of our planning and implementation of our tracking stock structure. From the start, we have always viewed our structure as one that is based on sound business considerations. I can state for the record we never considered tax avoidance as a reason to establish our tracking stock structure.

Without tracking stock though, it is quite likely that U.S. Steel, which is our steel unit, would have substantially scaled back operations and suffered severe financial distress. Instead, it has become the most viable integrated steel company in its industry, with good-paying jobs, and operations resulting in substantial payments of income and payroll taxes to Federal, State, and local governments. Similarly, because of the investments we have been able to make by virtue of the financial flexibility afforded by our structure, our Marathon energy unit is considered to have one of the best growth production profiles in the industry.

But Treasury asserts that tracking stock might be an indirect way to accomplish tax-free spinoffs under section 355 of the Code. To the contrary, tracking stock is used to keep businesses together instead of divesting of them. Tracking stock is not the economic equivalent of a disposition of a business.

USX, for example, issued what we called Delhi tracking stock in 1992, to create a separate group in order to grow the gas gathering and transmission business. Five years later, we decided to exit that business. Delhi assets were sold to a third party and a taxable transaction resulted in $208 million of taxes payable. In addition, Delhi tracking stock shareholders were subsequently taxed as a result of the taxable redemption of their shares. If taxes were our primary consideration, the original transaction in 1992 would have been rearranged to avoid taxes through a spinoff to shareholders.

Finally, there appears to be a Treasury concern that tracking stock will become a widely used tax avoidance mechanism in the future. Corporations don't issue tracking stock for tax reasons. USX, for example, looked at a variety of alternatives in 1991 when we implemented it. We were under pressure at that time to bust up the company into two companies—a steel company and an energy company. This could have been accomplished as a section 355 tax-free spinoff. We rejected the spinoff alternative, purely for sound business reasons, the most notable of which was a concern about the economic viability of our steel unit at that time as a stand-alone company.

So, in summary, let me say a tax on tracking stock would be counterproductive for job creation and capital formation. It would accomplish no meaningful improvement in U.S. tax policy or revenues. Indeed, it would have a contrary effect. Treasury can utilize existing tools, such as regulations and pronouncements to deal with inappropriate uses of tax tracking stock if and when they arise.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of Robert Hernandez, Alliance of Tracking Stock Stakeholders, and Vice Chairman and Chief Financial Officer, USX Corporation, Pittsburgh, Pennsylvania

POSITION STATEMENT

The Administration's proposal to impose a tax on the issuance of tracking stock (Tracking Stock) is unsound tax policy which, if enacted, will restrain new business and technology investment and development, cost jobs, cause severe harm to companies with Tracking Stock presently outstanding, and reduce business expansion. Therefore, this proposal should be rejected.

- The issuance of Tracking Stock is motivated by compelling business needs. It provides a market-efficient source of capital, particularly to corporations attempting to grow lines of business that would not be valued appropriately by the equity markets without Tracking Stock.
- The proposal, if passed, would not only eliminate a valuable source of capital to new businesses, but could also force companies with approximately $400 billion of equity securities outstanding to recapitalize at a considerable cost to them and to their shareholders.
- Treasury has authority to deal with Tracking Stock under current law. If Treasury becomes aware of inappropriate uses of Tracking Stock, it should resolve the issues administratively (through Treasury regulations and pronouncements) in a way that avoids adverse consequences to business-driven Tracking Stock issuers.
- The revenue estimates are unrealistic. The proposal would economically eliminate the use of Tracking Stock and provide little if any revenue to the Treasury.

DEFINITION OF TRACKING STOCK

Tracking Stock is a type of equity security issued by some companies to track the performance or value of one or more separate businesses of the issuing corporation. The holder of Tracking Stock has the right to share in the earnings or value of less than all of the corporate issuer's earnings or assets. The Tracking Stock instrument has developed largely in response to the dual economies arising from the equity market's preference for "pure-play" securities (i.e., pure, single line of business companies) and the debt market's preference for diversified corporate balance sheets.

BUSINESS CONSIDERATIONS

Since General Motors first used it as an acquisition currency in September 1984, to acquire Electronic Data Systems Corporation (EDS), Tracking Stock has found wide receptivity by shareholders in North America.

To date, a total of 15 public companies have issued 37 separate Tracking Stocks for a variety of business reasons including :

- Acquisitions
- Growth of start-up businesses
- Source of equity capital
- Creation of stock-based employee incentive programs
- Continuation of economies of scale for administrative costs
- Retention of operating synergies
- Maintenance of consolidated credit and existing borrowing arrangements
- Valuation enhancement
- Increasing shareholder knowledge, and
- Broadening of the investor base

Numerous real-life examples demonstrate the beneficial impact that capital, raised through the issuance of Tracking Stock, has had on the U.S. economy:

- USX Corporation raised sufficient capital, through its U.S. Steel Tracking Stock, to modernize its steel operations and transform U.S. Steel from a company that generated billions of dollars in losses throughout most of the 80's into a more efficient steel company. It is the largest employer in the domestic steel industry, with high paying jobs, generating taxable income rather than losses and paying substantial income and payroll taxes to federal, state and local governments.
- Genzyme Corporation, a biotechnology company founded in 1981, develops innovative products and services to prevent, diagnose, and treat serious and life-threatening diseases. It initiated its use of Tracking Stock in 1994 when it founded a new program to develop tissue repair technologies. More recently, it adopted a new Tracking Stock to fund molecular oncology research, including cancer vaccine clinical trials in breast, ovarian and skin cancer.
- Perkin-Elmer, a high technology company, chose Tracking Stock for several business reasons including: facilitating new business and technology development;

recruiting and retaining key employees; exposing and facilitating appropriate valuation for new technology opportunities; and providing flexibility for raising future capital and optimizing further development and expansion of each of its businesses.

For more detail, see the attached case histories of these companies.

Barring a replacement source of capital, the economic benefits of Tracking Stock, to these and other companies, will be substantially eliminated if a tax is imposed on issuance.

FINANCIAL MARKET IMPACT OF THE ADMINISTRATION'S BUDGET PROPOSAL TO TAX TRACKING STOCK

• Should the Tracking Stock proposal be enacted and any future issuances of Tracking Stock deemed a taxable sale, companies currently capitalized with Tracking Stock, and their shareholders, would be severely impacted. The imposition of corporate tax upon the issuance of equity effectively would shut down a Tracking Stock company's ability to access the equity capital market.

• Their ability to raise capital through the debt market would be severely reduced. Such a provision would undermine Tracking Stock companies' credit worthiness in the market place since they would be unable to strengthen their balance sheets and build their business in a cost efficient manner.

• This proposal precludes companies with Tracking Stock from being able to engage in ordinary non-taxable corporate reorganizations (e.g., stock for stock exchanges) thus limiting their ability to compete with companies with traditional stock structures.

• As a result of these consequences, investors would see Tracking Stock as an inefficient capital structure and equity valuations would suffer.

• Ultimately, as a result of this Tracking Stock proposal, approximately $400 billion of equity securities could need to be restructured at great cost and under intense market pressure causing a loss of shareholder investment and competitive vulnerability.

• For the high-technology industry in particular, those companies would lose a medium used to attract and retain key personnel.

TAX CONSIDERATIONS

Treasury expresses a concern that Tracking Stock has been used to circumvent established corporate tax rules in Subchapter C, in particular the spin-off requirements of section 355, including the recently enacted Morris Trust provisions. The case histories included herein and the facts of other Tracking Stock issuances establish that Tracking Stock transactions have been carried out for compelling business reasons. These transactions have not been tax motivated and in particular have not circumvented the section 355 rules.

• Tracking Stock is consistent with Subchapter C of the Internal Revenue Code because the tracked business remains in the same corporation and the Tracking Stock represents equity in that same corporation. For the same reasons, Tracking Stock does not reduce a corporation's tax liability compared to its tax liability prior to the issuance of Tracking Stock. Thus, revenues to the U.S. Treasury are the same before and after the initial transaction. If the tracked business is successful, however, it will generate taxable income, create jobs and pay additional taxes to federal, state and local governments. Likewise, increased equity valuations generate additional capital gains for individuals.

• Unlike Morris Trust transactions, corporations do not use Tracking Stock to dispose of businesses tax-free. Tracking Stock is a vehicle used for building and maintaining business assets within a single corporation.

• Tracking Stock does not result in a sale of the tracked business. Subsequent to adopting Tracking Stock, a corporation will recognize gain on any future disposition of its assets, unless all of the provisions of Section 355 are satisfied.

• Corporations do not issue Tracking Stock for tax reasons. The fiduciary responsibilities incumbent on the directors of a corporation with Tracking Stock (i.e., to multiple shareholder interests) far outweigh any conceivable tax motivation.

• Legislation is unnecessary. Treasury has authority to address transactions it perceives as inappropriate under current law, through regulations and pronouncements, in a way that avoids adverse consequences to business-motivated Tracking Stock issuers.

• A statutory attack is unnecessary and inappropriate because:

—It harms innocent corporations, impairing their equity and adversely impacting their ability to raise capital.

—It harms shareholders, by reducing the market value of their shares.

—It harms employees and customers. Unless a replacement source of capital is found, businesses will scale back operations, adversely impacting employees, customers, and the communities in which the companies operate.

—It adds more complexity to the Internal Revenue Code.

• Tracking Stock transactions undertaken to-date have been driven by business considerations. The complexities associated with the issuance of Tracking Stock should prevent it from becoming a tax motivated vehicle. Tracking Stock is only appropriate for a small number of companies for which the business advantages outweigh the complexities. These complexities include:

—The fiduciary responsibilities of the Board of Directors to shareholders of all classes of common stock, which may create conflicts

—Each Tracking Stock business has continued exposure to the liabilities of the consolidated entity.

• The published revenue estimates for the proposal to tax issuance of Tracking Stock are unrealistic. Subjecting future issuances to tax would increase costs to a level that would preclude future issuances, except in dire circumstances. Thus, the legislation would generate little or no revenue.

CONCLUSION

• The issuance of Tracking Stock is motivated by compelling business needs. Treasury's Tracking Stock proposal will disrupt financial markets and cause severe harm to companies with Tracking Stock since it will not only restrict access to capital in the future, but also require massive financial re-engineering for some companies. Individual investors, and possibly entire communities in which Tracking Stock companies operate, will be adversely affected as a result of the competitive pressures this tax would impose.

Three Tracking Stock Case Studies are also Submitted as Attachments to this Statement:

• USX Corporation
• Genzyme Corporation
• The Perkin-Elmer Coporation

Alliance of Tracking Stock Stakeholders.—The Alliance is an informal group of companies that currently utilize or are considering using Tracking Stock. These companies share a common concern for the value of shareholder investment in tracking stocks, as well as their continued ability to meet various business objectives through the issuance of tracking stock. For further information, contact Scott Salmon, Manager, Governmental Affairs, USX Corporation, 202–783–6797.

USX Corporation Tracking Stock Case Study

COMPANY OVERVIEW

USX Corporation is a diversified corporation headquartered in Pittsburgh, PA, engaged in the energy business through its Marathon Oil Group and in the steel business through its U.S. Steel Group. USX, formerly United States Steel Corporation, was founded in 1901 and acquired Marathon Oil Company in 1982 (Marathon was formed in 1887). U.S. Steel is the largest steel producer in the U.S. and today employs approximately 19,600, down dramatically from about 149,000 in 1980. Marathon is a significant worldwide producer of oil and gas and the fourth largest refiner in the U.S., employing almost 33,000.

USX Corporation is currently represented in the equity market by two classes of tracking stock—USX Marathon Group Common Stock ("MRO") and USX U.S. Steel Group Common Stock ("X"). Total market capitalization at December 31, 1998, was $12.6 billion. Consolidated revenues for 1998 were $28.3 billion; with net assets of $21.1 billion.

USX TRACKING STOCK BUSINESS CONSIDERATIONS

In the late 1980's, USX' largest shareholder, Carl Icahn, held 13.3% of USX' stock, and advocated a proposal to spin-off the steel division as a separate company due to his belief that USX presented a confusing mix of businesses to investors and that the Marathon energy business was significantly undervalued relative to its energy sector peers.

Although a tax-free spin-off could have been accomplished, management objected to the Icahn proposal for a number of compelling business reasons:

- USX was facing significant internal challenges including heavy capital expenditure requirements for plant modernization, reserve development and environmental compliance, as well as substantial debt maturities and significant retiree pension and medical costs;
- USX was facing a challenging external economic environment for both its energy and steel businesses;
- A spin-off was not judged to be in the best interests of USX's creditors, stockholders, and employees;
- There were concerns about the economic viability of a standalone steel company;
- Incremental costs to operate standalone companies would have been in excess of $70–$90 million per year in increased administrative costs, state and local taxes, interest costs and insurance costs;
- Neither of the standalone entities would have been investment grade.

The Icahn spin-off proposal was defeated at the May 1990 shareholders meeting. However, as an alternative to the Icahn proposal, USX management soon thereafter proposed creating U.S. Steel and Marathon Tracking Stocks. The Tracking Stock proposal:

- Established separate equity securities to trade based upon the performance of the U.S. Steel and Marathon businesses
- Retained the benefits of a consolidated corporation while providing for separate equity market valuations for its steel and energy businesses. The USX Tracking Stock capital structure results in incremental cost savings of approximately $70 to $90 million annually. These cost savings are achieved through savings in insurance costs, administrative costs, State and Local taxes, and interest savings.
- Created flexibility for shareholders to hold the stock of either the steel business, the energy business or both businesses, and
- Maintained flexibility for USX to continue to pursue other alternatives for its steel business, including a joint venture or sale.

USX did not seek to circumvent the rules under Section 355 when it opted to issue Tracking Stock. USX did consider a tax-free spin-off of stock of its steel business to its shareholders and was advised by outside counsel that a tax-free spin-off would qualify under Section 355. The USX fact pattern strongly supported this opinion because USX owned 100% of the steel operations; a spin-off would have effected complete separation of the steel assets from USX through the distribution to the USX shareholders; both the steel and oil businesses were 5-year active businesses within the meaning of Section 355(b); and, there were good business reasons for a complete separation of the businesses.

USX MARKET VALUATION AND TRACKING STOCK

Prior to the announcement of the Tracking Stock Proposal, it was clear that the valuation of USX was heavily penalized by the market. Although USX was valued in line with its steel peers, the stock traded at a significant discount to its energy peers. This occurred despite the fact 75% of the company's total value was attributable to Marathon's activities.

On January 31, 1991, the day following the announcement of its Tracking Stock Proposal, USX's stock closed 8.2% higher—increasing its market value by more than $600 million. The Tracking Stock Proposal received a 96% vote of approval at USX's shareholders' meeting on May 6, 1991. As a direct result of the Tracking Stock structure, USX also experienced a pick-up of 29 additional equity research analysts.

Currently, Marathon's Tracking Stock trades based on the fundamentals of its energy business. U.S. Steel's Tracking Stock trades based on the performance of the steel business, however, during weak steel business cycles, U.S. Steel trades at a premium to its peers due to its stronger consolidated balance sheet (a result of the Tracking Stock structure). To date, USX has raised over $2.5 billion in eight equity offerings using Tracking Stock.

THE USX DELHI GAS GATHERING AND TRANSMISSION BUSINESS

On September 24, 1992, USX created its third Tracking Stock through a $144 million initial public offering (IPO) of its Delhi natural gas gathering Tracking Stock. The Delhi issuance represented the first IPO of a Tracking Stock.

USX sold the assets comprising the Delhi business to Koch Industries in late 1997 in a taxable transaction incurring $208 million of taxes payable, including $193 million in federal taxes. Net proceeds of $195 million were used to redeem all of the Delhi Tracking Stock, a taxable transaction to the shareholders.

Delhi Transaction Results

Delhi Sale Price ($MM)	$762
Less: Debt, Other Liabilities and Adjustments ($MM)	359
Less: Corporate Taxes Payable by USX ($MM)	208
Net Proceeds to Delhi Shareholders ($MM)	$195
Net Proceeds to Delhi Shareholders Per Share	$20.60
Delhi IPO Share Price in 1992	$16.00
% Increase to IPO Share Price	28.8%

If USX had chosen to spin-off Delhi to shareholders in 1992 (instead of issuing Tracking Stock), it could have disposed of the subsidiary to its shareholders at approximately the IPO price and USX would not have incurred taxes on the disposition.

In addition, if USX had issued conventional common stock in the IPO of Delhi (instead of issuing Tracking Stock), USX could have completed a spin-off, merger or joint venture transaction at a comparable value to the sale price without incurring taxes.

Tracking Stock Facilitates Capital Formation not Tax Avoidance

Tracking Stock is a financing innovation that allows companies with more than one line of business to raise capital efficiently by tapping the value securities markets place on "pure play" equity instruments.

Tracking Stock is consistent with the intent of Subchapter C because businesses remain in the same corporation and Tracking Stock will not reduce a corporation's tax liability compared with its tax liability prior to the issuance of Tracking Stock. Corporate tax revenues to the U.S. Treasury are essentially the same before and after a Tracking Stock transaction.

Tracking Stock does not result in a "sale" of the tracked business. A corporation will recognize gain on any future disposition of its assets unless all of the provisions of Section 355 are satisfied. Tracking Stock involves the antithesis of situations giving rise to the anti-Morris Trust legislation and, therefore, does not threaten Section 355(e).

Legislation is unnecessary—Congress and the IRS have recognized the existence of Tracking Stock, and abusive transactions can be addressed under current law. Section 355(d)(6)(B)(iii), for example, prevents a third-party from buying up Tracking Stock in order to spin-off the tracked business. In addition, the IRS has issued several Section 355 rulings to corporations that have Tracking Stock outstanding (e.g. GM).

Due to the business complexities of Tracking Stock, it should remain appropriate only for companies for which the business advantages outweigh the complexities. These same considerations augur against it ever becoming a tax-motivated vehicle.

Conclusions

The Administration's proposal to impose a tax on the issuance of Tracking Stock is unsound tax policy which, if enacted, will restrain new business and technology investment and development, cost jobs, cause severe harm to companies (and their investors) with Tracking Stock outstanding, and reduce business expansion.

Treasury's new tax proposal to Tax the Issuance of Tracking Stock should be rejected.

Genzyme Corporation: Background Use of Tracking Stock

Genzyme Corporation (Cambridge, MA) is a biotechnology company that develops innovative products and services to prevent, diagnose, and treat serious and life-threatening diseases. The company was founded in 1981 and has developed extensive capabilities in research and development, manufacturing, marketing, and other disciplines necessary for success in the health care marketplace. One of the top five biotech companies in the world, Genzyme had 1997 revenues of $609 million, R&D

expenses of $90 million, pre-tax income of $26 million, and income taxes of $12 million.[1]

CURRENT CORPORATE STRUCTURE

Genzyme has adopted a corporate structure that best supports the needs of its developing businesses. This structure consists of three divisions, each of which has its own common stock intended to reflect its value and track its performance. These stocks are known as "tracking stocks."[2]

Genzyme General (Nasdaq:GENZ) develops, manufactures, and markets pharmaceuticals for a variety of unmet medical needs, but has a special focus on treatments for rare genetic disorders that disable or kill children (such as Gaucher disease, Fabry disease, Pompe disease, and cystic fibrosis). This division also makes a variety of diagnostic test kits, provides genetic diagnostic services, and has a significant surgical product business.

Genzyme Tissue Repair (Nasdaq:GZTR) develops, manufactures, and markets therapies consisting of human cells which are cultured from a tiny sample of a patient's healthy tissue and surgically implanted to repair or replace damaged tissue, such as skin for severe burn victims and knee cartilage for injured athletes. This division is also investigating the use of brain cells from pig fetuses to treat Parkinson's and Huntington's diseases.

Genzyme Molecular Oncology (Nasdaq:GZMO) is developing a new generation of chemotherapy products, focusing on cancer vaccines and angiogenesis (tumor blood vessel) inhibitors. It has initiated cancer vaccine trials in melanoma patients and expects to initiate trials in breast and ovarian cancer shortly.

ADMINISTRATION'S PROPOSAL TO TAX THE ISSUANCE OF TRACKING STOCKS

The Administration proposes to tax the issuance of tracking stocks. According to the Treasury Department's "Green Book," this proposal is based on Treasury's assumption that companies use tracking stock to sell subsidiaries without incurring tax liability on their profits. Treasury claims enactment of this proposal would raise $600 million in new revenues over the next 5 years. Treasury also claims its proposal would not be retroactive, though it is unclear whether companies who issue new shares of existing tracking stocks would be subjected to the tax.

This proposal reflects a fundamental misunderstanding about why companies issue tracking stocks. The faulty premise is discussed in detail below, but is illustrated by the following:

Genzyme's use of tracking stocks has not—and will not—produce any tax benefits for the company. The company pays taxes based on the earnings of the entire corporation, which is a single entity for tax purposes regardless of the types of securities it issues to its investors.

Genzyme instituted its tracking stock structure as a means of financing the acquisition of the companies that comprise the principal assets of the new divisions. This use is the opposite of Treasury's contention that tracking stocks are used to achieve tax-free sales.

Only 12 companies have issued tracking stocks in the last 15 years. If tracking stocks truly offered a means for achieving permanent tax avoidance on the divestiture of subsidiaries, one would expect it to have attracted many more adherents than have appeared during a period of vigorous merger and acquisition activity in which hundreds of companies have divested themselves of subsidiaries.

Tracking stock issuance does not transfer ownership. When a company replaces a single class of shareholder equity with two (or more) classes of tracking stock equities, the total value of the newly issued equities equals the total value of the original equities which must be forfeited in exchange. The newly-issued tracking stocks literally replace the original shares in the portfolios of the company's investors.[3] This substitution is not a divestiture: no corporate assets are transferred, no management control is forfeited, no cash or other consideration is paid, and no corporate

[1] Consolidated financial data for all company operations. Audited financial data for 1998 not yet available.

[2] Genzyme Transgenics Corporation (Nasdaq:GZTC) is a separate corporation in which Genzyme Corporation holds a minority stake (about 41%) of outstanding stock. These shares have been assigned to Genzyme General. Genzyme Transgenics develops and produces recombinant proteins and monoclonal antibodies in the milk of genetically engineered animals for medical uses.

[3] When investors sell these tracking stocks, they will be required to pay tax on their capital gains if the sale price exceeds their adjusted basis in the tracking stock shares.

liabilities are relieved.[4] Furthermore, the subsequent issuance of new tracking stock shares will raise capital for the exclusive use of the tracked division and does not increase the assets of any other division.

This proposal would create a substantial new tax burden. In effect, the Administration proposes taxing tracking stock companies each time they raise capital for R&D and other legitimate business activities merely because newly issued shares would track a single division, rather than the entire company. Tracking stock companies would become the only companies in the country to be taxed on paid-in capital.

This proposal would not raise revenue. Tracking stock issuance is currently tax-neutral. If it were it to be taxed, no company would ever issue it and it would not raise $600 million.

BENEFITS OF TRACKING STOCKS OVER CONSOLIDATION

Enhances capital formation by enlarging the pool of investors for whom Genzyme could offer a stock consistent with their investment goals. Tracking stocks provide investors with the ability to select the single business unit that best reflects their growth expectations and risk tolerance, rather than the traditional all-or-nothing investment choice offered by most diversified companies. Genzyme is the most diversified company in the biotech industry, with respect to both its product/service/technology mix and the investment risk associated with its businesses. For example, Genzyme General offers proven earnings, consistent growth, moderate volatility, and high liquidity, while Genzyme Tissue Repair and Genzyme Molecular Oncology are earlier-stage, longer-term investments that represent "pure plays" in their respective technologies. Each Genzyme stock is likely to appeal to some investors who would not find a consolidated common stock to meet their investment criteria.

Improves overall shareholder value by providing visibility to pipeline products whose value might otherwise be overlooked. Once a biotech company launches its first products, stock analysts tend to switch their focus from the value of the company's pipeline to its ability to sustain revenue and earnings growth for currently marketed products. Tracking stock is a mechanism which forces an independent valuation of unprofitable, R&D-intensive divisions.

Reduces disincentives to making large investments in long-term R&D programs. Once a company achieves profitability, management is often judged on earnings performance and must contend with a shareholder base that is not always tolerant of early-stage R&D programs. Such programs rarely increase the price-earnings multiple, so managers who make such investments are almost always penalized with reduced stock prices. By creating an investment vehicle that attracts more risk-tolerant investors, management can invest more in science and technology programs without eroding the company's market value.

Provides investors with more information about the various business units of the company. Genzyme tracking stockholders receive more detailed information than is ordinarily reported by individual business units of public companies (such as separate financial statements, management's discussion and analysis, descriptions of business, and other information).

BENEFITS OF TRACKING STOCKS OVER DIVESTITURE

Maintains access to a seasoned management team and other resources that would not be available to a small independent company. Genzyme's expertise in such areas as R&D, clinical and regulatory affairs, manufacturing, and administration are generally broader and deeper than is typically available to start-up companies similar to its smaller divisions.

Provides access to debt capital based on the financial strength of the entire corporation. Biotech companies have huge capital requirements, lengthy product development cycles, and high risks of failure. Businesses with these attributes find it difficult to borrow funds and risk the possibility that poor stock market conditions, rather than poor corporate performance, could destroy them. Weak equity markets for small cap companies outside of the Internet industry have forced many start-ups (including both Genzyme Tissue Repair and Genzyme Molecular Oncology) to cancel or postpone public offerings. As units of Genzyme Corporation, however,

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[4] For example, if an investor were to purchase 100% of Genzyme Tissue Repair tracking stock—which would cost $54 million at current market prices—he would gain neither ownership nor management control of that division. He would, however, possess the right to any and all future dividends attributable to that division, as well as voting and liquidation rights equal to the small portion of Genzyme Corporation represented by these shares.

these businesses can borrow from the company, which can access a $200+ million bank line of credit and $250 million in public convertible debt.

Enhances incentives for the management and staff of each division to increase shareholder value. The use of tracking stock options enables the company to motivate employees with a share of the value they help to create.

CONCLUSION:

Tracking stocks have legitimate business uses and are not vehicles for tax avoidance. Proposals to tax their issuance are misguided because they would more likely result in re-consolidation than in new federal revenues. This outcome would undermine investor choice, shareholder value, and start-up business stability in companies like Genzyme that use tracking stocks to grow their businesses.

APPENDIX: GENZYME'S CAPITAL FORMATION HISTORY

Genzyme's 17-year history of capital formation—during which it raised more than $1 billion to support R&D, technology development, manufacturing, and other activities—illustrates how tracking stocks can be used to build a strong and diversified company.

During the five years after its founding in 1981, Genzyme was a privately-held company whose operations were funded by venture capital and private placements totaling $4 million. The company went public in 1986, raising $22 million in its initial public offering (IPO). Follow-on offerings, which were made in 1989 and 1991, raised an additional $173 million. Off-balance sheet offerings contributed an additional $122 million in research and development funding for specified projects.

In 1991, Genzyme obtained FDA approval for its first product, a drug to treat a rare (and sometimes fatal) genetic disorder called Gaucher disease. To facilitate continued growth and innovation, the company engaged in a number of acquisitions, seeking out other biotechnology companies whose research programs, while promising, were not financially sustainable without additional capital resources that were more readily available to Genzyme.

Ironically, it was to accomplish such an acquisition—and not for purposes of divestiture—that Genzyme adopted its use of tracking stocks in December 1994. The acquired company was another Massachusetts company, BioSurface Technology, which had developed exciting techniques for re-growing human tissue for transplantation.

To finance the acquisition, Genzyme common stock was replaced by two stocks: one tracking a newly created division—named Genzyme Tissue Repair (GTR)—into which BioSurface was merged, and the other tracking the remainder of the company—renamed Genzyme General. BioSurface shareholders were granted GTR tracking stock in exchange for their BioSurface shares. And since additional Genzyme assets were allocated to GTR, GTR tracking stock was also issued to all Genzyme Corporation shareholders as a non-taxable dividend.

In 1995, GTR issued additional shares in an initial public offering (IPO) in which it raised $42 million. In 1996, a second offering raised $29 million; in 1997, a third offering raised $13 million. In addition, GTR has access to an $18 million line of credit from the corporation.

In 1998, Genzyme General purchased another biotech company—Pharmagenics—which had developed a new technology to analyze the differences in how genes are expressed in cancerous tissue versus healthy tissue. This technology appears to be a powerful tool in the development of new approaches to treating cancer. Once again, Genzyme combined the acquired company with some existing General division assets, and created another tracking stock, Genzyme Molecular Oncology (GMO). Due to poor market conditions for biotech start-ups, GMO has postponed its IPO and has instead obtained a private placement of $19 million of convertible debt. It also has access to a line of credit from the corporation under terms similar to those provided to GTR.

Last year, Genzyme General also raised $250 million in a private placement of convertible debt.

The Perkin-Elmer Corporation

BACKGROUND AND DECISION TO UTILIZE TRACKING STOCK

Perkin-Elmer is a sixty year-old high technology company, headquartered in Wilton, Connecticut.

The company was founded during World War II when Germany was the dominant worldwide supplier of optical equipment such as telescopes and sighting instruments.

• Perkin-Elmer's business evolved from optics into several other technologies, including scientific equipment, guidance and navigation equipment, semiconductor manufacturing equipment and biotech systems.

• The company has distinguished itself with its long-term consistency and success in developing new technologies into successful products and businesses

• Currently, Perkin-Elmer is divided into three primary business units: Analytical Instruments, Biosystems, and the recently formed Celera Genomics

• These units involved different technologies, markets and financial models

In order to survive constantly over its history as a high technology company, Perkin-Elmer has been forced to evolve, particularly as technology development accelerates and becomes more competitive.

Currently, several factors have prompted management to broadly assess structural alternatives to facilitate further evolution and success. The *clear* structure of choice has been determined to be tracking stock. Motivating factors include the following:

—Meeting investor demands, involving business and technology comprehension, appreciation, focus and "pure play"

—Accommodating various investor risk/reward interests, recognizing that each business/technology has a substantially different financial profile

—Recruiting and retaining employees in businesses ranging from start-ups to relatively mature businesses, while also facilitating employee movement between business units

—Providing an optimal "incubator" for development of new technologies—where a fast moving and focused start-up environment can be supported by broader and proven resources. These resources include management, technology, capital, administrative resources and reputation (both for customers and investors)

—Facilitating ongoing visibility and appreciation of business, financial, and technological progress for investors, customers, and employees through increased disclosure and separate financial statements

—Maximizing total shareholder value, particularly by exposing technologies and opportunities that may otherwise be "buried" within a larger business structure

—Distinguishing related businesses in their respective markets while facilitating ongoing technology synergies

—Optimizing an acquisition currency for further development and expansion of each business

—Providing an optimal tool for raising future capital, even though Perkin-Elmer's current tracking stock offering is not being used to raise capital

For Perkin-Elmer's new genomics business, tracking stock was identified as best accommodating all of these interests, and the company has taken extensive steps to accomplish tracking stock, all in reliance on current law.

These steps include: creating our new Celera Genomics business unit, recruiting employees, granting stock options and filing with the SEC—all with tracking stock as a foundation:

• Although tracking stock has yet to be officially implemented, anticipation of such has been enthusiastically received by investors, employees and customers

Proposed New Tax Legislation and Effects on Perkin-Elmer

Tracking stock was also chosen as the structure of choice based on facilitating Perkin-Elmer's further evolution and likely issuances of additional classes of tracking stock.

Throughout all of the analysis and considerations addressed above, taxes were not a factor.

While not a factor, critical reliance was placed on the fact that the tracking stock restructuring would not carry any tax penalties versus the status quo.

The presumption that tracking stock is used to disguise spin-offs and save taxes is totally inapplicable to Perkin-Elmer. Although a separate tracking stock, Perkin-Elmer's Celera Genomics will necessarily continue to be an integral part of the Perkin-Elmer family.

A spin-off of Celera Genomics was not feasible for many reasons, including the ongoing need for, and synergies with, Perkin-Elmer's management, technologies, capital availability and reputation

• Highlighting the inappropriateness of assuming that tracking stocks are disguised spin-offs is the current example of Perkin-Elmer's Analytical Instruments business. Due to the lack of comparable synergies toward that business, Perkin-

Elmer has specifically decided not to make its Instruments business another class of tracking stock; it has decided to sell that business to a third party. Tax considerations were not a motivating factor in either case

Perkin-Elmer management has not considered current tax law as an advantage or "loophole" with respect to our proposed tracking stock because no alternative involved spinning off or selling the genomics business. A spin-off or sale would be unhealthy and perhaps fatal to the young business and would be detrimental to shareholders, employees and the development of science and technology. Management views tracking stock to be a neutral tax event as compared to viable alternatives, all of which involve retention of the genomics business within the Perkin-Elmer family.

The current tax proposal could represent a fatal blow to Perkin-Elmer's proposed restructuring. From Perkin-Elmer's perspective, the proposed legislation would not eliminate a tax loophole; it would eliminate tracking stock as a viable alternative by imposing a significant tax penalty on the structure. This, in turn, would represent an obstacle to Perkin-Elmer's further success and evolution. As such, it would impede the effective development of science, technology, medicine and corresponding contributions toward employment and success for American companies.

Chairman ARCHER. Thank you, Mr. Hernandez.

Mr. Kies and Mr. Weinberger, I think both of you were in the room during the testimony of the previous panel. You listened to what Mr. Tucker, representing the ABA, said about tax shelters. Where do you differ with him?

Mr. KIES. Well, Mr. Chairman, Mr. Tucker was careful I think to say that actually his statements were not on behalf of the American Bar Association itself, other than his opposition to taxing the investment income of their trade association, of which I am a member. So his position is not yet the official position of the ABA.

I think where we basically differ is a different view of the tools that are available to the Service today. The IRS has, as we said in our testimony, a substantial array of tools at its disposal to deal with what are real abuse situations, and indeed has been reasonably successful in using them.

The concern that we have is that the kind of discretion that would be given to the Service would go way beyond anything that is necessary for them to deal with problem situations that they legitimately have to deal with, and that what they should really do is use the tools that are at their disposal, including what was enacted in 1997 that has not yet been implemented through regulations.

Chairman ARCHER. Mr. Weinberger, do you have anything to add to that?

Mr. WEINBERGER. No, other than to say that when you look at the written testimony of the ABA, I think there is a lot more in common with what we said than was apparent in the verbal testimony. One of the suggestions in the ABA's written testimony was "we recommend that congressional response to the tax shelter problem be measured and appropriate. It should not overreach. It should not risk inhibiting legitimate business transactions."

That is, I think, on all fours with what we are saying. They did not reference anywhere in their verbal or written testimony the changes that were made in 1997 expanding the tax shelter reporting requirement and substantial understatement penalty definition or the reason they were enacted. So I think that I would just focus more on the existing tools at hand.

Chairman ARCHER. He, I believe, alluded to a need for greater disclosure. Would you agree with that?

Mr. KIES. Well again, what the 1997 act would do is require disclosure of tax shelter activities where there is confidentiality involved. The Service ought to implement the authority that they have got so that they can take advantage of that.

Overdisclosure, though, should be looked at cautiously. If you cause taxpayers to have to disclose every transaction they enter into, what you will get is a blizzard of paper at the IRS that will not be useful as an effective tool in enforcement. Right now, the tax returns filed by corporate taxpayers, as you have seen in other testimony before this Committee, measure many feet in height. There is a tremendous amount of disclosure that goes on today. Effective auditing can address most of the problems to the extent that they actually exist.

Mr. WEINBERGER. Mr. Chairman, I want to concur with that. In fact, when the Treasury asked Congress to pass the proposal that you passed in 1997, providing expanded tax shelter registration rules that have not yet been implemented, they specifically said in the Green Book, “many corporate tax shelters are not registered with the IRS . . . [R]equiring registration of tax shelters would result in the IRS receiving useful information at an earlier date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better informed judgments regarding audits, and so on, and so on.”

We think that is why it is premature for these sweeping new proposals to take place before those proposals are even implemented.

Chairman ARCHER. In the opinion of each of you, are there abuses out there?

Mr. KIES. There certainly are bad actors. There always have been. But the government has not decided, for example, to take away everybody’s driver’s license because there are a few speeders. To impose sweeping or give sweeping discretion to the IRS which could be used against all corporate taxpayers because there are a few problem actors, we think would be a misguided thing to do.

The audit process and the other tools available to the Service can be effectively used to police bad actors. We think most corporate taxpayers are trying to actually get the answer right, file returns that correctly report their liability, while serving the responsibility they have to their shareholders to not overpay their liability. We think that is what most corporate tax managers are trying to accomplish. For those that are the bad players, the Service ought to go after them. I don’t think anybody would defend protecting those types of taxpayers.

Chairman ARCHER.

Mr. Doggett.

Mr. DOGGETT. Thank you very much. Mr. Kies, I read in the Sunday New York Times that you have been assigned the lead role of drafting the Republican Social Security plan. How are you coming?

Mr. KIES. I am unaware of that assignment.

Mr. DOGGETT. It’s inaccurate? You are not doing that?

Mr. KIES. I am happy to talk to anybody about Social Security, both Democrats and Republicans, and I have. I participated in the

White House Conference on Social Security at the White House's request. I have been happy to talk about the issue.

Mr. DOGGETT. But the New York Times story is in error and you are not drafting the Republican plan?

Mr. KIES. I am no longer with the Congress. I provide would be happy to provide informal advice to anybody who is interested in it.

Mr. DOGGETT. So the report is erroneous?

Mr. KIES. That is correct.

Mr. DOGGETT. Thank you. If I understand your written and oral testimony correctly, you oppose every single proposal that the administration has advanced relating to corporate tax shelters?

Mr. KIES. That is precisely correct.

Mr. DOGGETT. You feel that the best thing for this Congress to do about tax shelter hustlers for the time being is to do nothing?

Mr. KIES. I think the best thing that Congress could do is to give stern and direct directions to Treasury and to the Internal Revenue Service to utilize the tools that they have at their disposal to address these kind of problems.

Mr. DOGGETT. And you recommend that the Congress take no further legislative action of any kind concerning corporate tax shelter hustlers this year?

Mr. KIES. I think the Congress ought to wait and see if what was given to the Service in 1997 is effectively addressing the problems that were identified then.

Mr. DOGGETT. Which is another way of saying do nothing, as far as legislative proposals. Correct?

Mr. KIES. That is correct.

Mr. DOGGETT. Now I want to be sure I understand how this process works, and whether the reports of it are accurate. At your firm, is it correct that contingency fees of up to 30 percent are charged on tax savings for corporate tax shelters and tax avoidance schemes?

Mr. KIES. Actually, I think you are referring to the Forbes article. That was a reference to, I believe, the proposal at the beginning of the article, which dealt with another firm's proposal.

Mr. DOGGETT. I am asking the question generically, though the Forbes article does refer specifically to your firm and to comments made by one of your partners here in the Washington office. But my question, without regard to Forbes, is whether or not it is true that there are charges of up to 30 percent on a contingency fee basis on tax avoidance schemes?

Mr. KIES. Mr. Doggett, we don't advise people on tax avoidance schemes. But if you are asking do we ever have contingency fee arrangements, there are situations—they are somewhat unusual—in which we provide advice which has contingencies associated with it, whereby we tell our clients that we are prepared to stand behind our advice, and if it turns out to be incorrect, to return fees that have been paid.

Mr. DOGGETT. So in short, if the corporate tax shelter, if you prefer that term, works, you get 30 percent of the amount that they save. If it doesn't work, they don't owe you anything. Is that the way it works?

Mr. KIES. The 30 percent, frankly, I don't know if we have any 30-percent arrangements.

Mr. DOGGETT. Your partner indicated you did, though I think it goes down to as low as 8 percent, he said.

Mr. KIES. Again, what I am saying is that there are contingency fee arrangements. The exact percentage, I am not aware of.

Mr. DOGGETT. That is the way it works though, whether it is 30 percent or 8 or 25, if you succeed on the tax shelter, your company shares in a good chunk of the savings, and if you don't succeed, the corporation owes your company nothing for the advice?

Mr. KIES. There are circumstances like that.

Mr. DOGGETT. Your partner also described this as a "new pricing model." Does that mean that this use of the contingency fee system on corporate tax shelters is relatively new?

Mr. KIES. Actually, there have been contingency fee arrangements for many years. Litigators use contingency fee arrangements both in tax and nontax.

Mr. DOGGETT. He also described what he referred to as black box products that are sold by your firm. Is that term familiar to you?

Mr. KIES. Actually I have never heard it used, but the context in which it appeared in the article was to describe a unique planning transaction. Frankly, every piece of advice that we give to a specific taxpayer is unique to that taxpayer. So the black box kind of sounds like it's mysterious, but I am not sure that it connotes any kind of unusual——

Mr. DOGGETT. He suggested that staffers at your office were required to come up with one new idea of this type per week. Is that correct?

Mr. KIES. No. That is not correct.

Mr. DOGGETT. And is it correct that there are up to 40 newly hired professional salesmen to pitch these corporate shelter ideas just in this office?

Mr. KIES. No. That's not correct. Firm-wide we have people who are actually relationship persons with the clients that we serve. Those people, part of their job is to bring to the attention of clients the range of services that we provide, which include State and local, pension planning, multinational. I mean there are people whose job is to help educate our clients about the range of services we provide. That is true of most of the professional firms today.

Mr. DOGGETT. Thank you.

Mr. KIES. Sure.

Chairman ARCHER.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Kies, I believe in your testimony you referred to a Judge Learned Hand.

Mr. KIES. Yes, sir.

Mr. COLLINS. A quote that is often referred to by Mr. Hand or by Judge Hand. What was that quote, sir?

Mr. KIES. Well, I don't know the precise quote, but the basic message that he had was that people don't have an obligation to maximize the tax liability that they pay.

The exact quote was, "A transaction, otherwise within an exception of the tax law, does not lose its immunity" that is, it's not available, "because it is actuated by a desire to avoid or if one chose, to evade taxation. Anyone may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."

What Judge Hand was basically saying is people are perfectly entitled to plan their transactions legally in a way that will lower their tax liability.

Mr. COLLINS. In other words, a taxpayer can seek advice as to how they would result in a minimum of taxation?

Mr. KIES. Not only can they do that, but as a matter of fact, corporate tax managers have the fiduciary obligation to their shareholders to plan their transactions that way.

Mr. COLLINS. Very good. Thank you, sir.

Thank you, Mr. Chairman.

Chairman ARCHER.

Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman. You know, I am really interested in sort of the macro issues here in terms of the revenue provisions. There are a lot of different categories of taxes. One is if a tax is different. I think you have a 32.6 percent corporate tax average. That could be different. It could be split up different ways. It could be an unfair tax.

The thing I am most interested in is the consequence taxes. When these tax provisions are put forward, what are the ones that have economic and national consequences? What are those ones that you think are important? That is what I am interested in. To anybody who wants to talk to it.

Mr. KIES. Mr. Houghton, in terms of—you mean the proposals that the administration has?

Mr. HOUGHTON. Right. Right.

Mr. KIES. Which ones would have economic consequences?

Mr. HOUGHTON. Right.

Mr. KIES. Well, obviously it depends on the amount of revenue they are raising. I mean ironically, the tax shelter provisions are only predicted by the Joint Committee to raise $300 million a year, so the economic consequence wouldn't seem to be very substantial. The consequence in terms of the ability of people to have any confidence as to what the rules are could be quite sweeping.

There are other proposals in here that have clear economic consequence. If you raise the cigarette taxes by $69 billion or whatever the number is, the economic consequence is that people that smoke, which is mainly low- and middle-income individuals, are going to experience an economic penalty. Consumption taxes clearly would get borne by the consumer. So an increase in the cigarette excise tax, an increase in the airline ticket fees, clearly get borne by the consumer.

Other proposals in here, for example, there is a wide range of proposals——

Mr. HOUGHTON. I guess what I am searching for is if you increase the airlines tax, does that mean that one fewer person flies? What is the economic consequence of some of these things?

Mr. KIES. The economists certainly predict that increases in excise taxes do decrease consumption. Indeed, if you ask the Joint

Committee, they could tell you from their model what would be the decreased consumption as a result of increasing those excise taxes. Same thing in the case of taxes, excise taxes on airline travel. There would be an impact in terms of decreased consumption.

Mr. HOUGHTON. Would you like to——

Mr. WEINBERGER. Well, Mr. Houghton, I guess to your generic question, I think any of the proposals that restrict the ability of companies to raise capital or to reorganize efficiently are going to hurt the overall profit to the company, which are a large reason for our continued surplus according to CBO. Part of the reasons we have expanding surpluses over the original projections was due to corporate profits, and there should be a high threshold to enact proposals that will have a negative effect on these companies' ability to either raise capital or effectively reorganize in an efficient manner.

Mr. KIES. That is an important point, because it gets to, for example, the tracking stock proposal.

Mr. HERNANDEZ. To that point, the Treasury's revenue estimates of I think it's $600 million, are unrealistic, because people just wouldn't issue tracking stock. But it does reduce the ability of companies to raise capital.

Mr. HOUGHTON. So that is a very significant issue.

OK. Well, thank you very much.

Chairman ARCHER.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

Following up on that question, my questions go to the issues you raised with regard to the life insurance provisions. And particularly, Mr. Wamberg, as it relates to the personal savings rate, which as you know is at a low ebb right now. Probably not since 1933 have we seen such a low personal savings rate in this country. In fact, it was even negative a couple months late last year. Everyone in the economic field, right, left or center, across the ideological spectrum, seems to agree that that is a very important indicator of the healthy economy into the future, that we can't sustain our economic growth without higher savings rates and more capital formation.

You talked about the administration's proposal to tax employer-owned life insurance. I am looking at your testimony. You focus more on the health insurance side, saying that that could affect fringes on the health side. The examples you use are primarily in that area. How would it affect the pension side? In particular, defined benefit plans, but also on the defined contribution side. In other words, a 401(k) or another kind of profit-sharing plan. How would that tend to affect the way it would work in the real world? Kind of following on Mr. Houghton's statement, what are the real-world impacts of these proposals?

Mr. WAMBERG. The question is a good one. It would have a severe impact for corporations to be able to keep their executive team together and put retention devices in and make sure that they stay with that company for the duration.

We have a labor shortage in this country in a lot of different sectors, but clearly in top management. Because of ERISA and because of continuing government limitations on what can be provided through a qualified pension plan, what can be provided through qualified defined contribution and profit sharing plans, and how much an employee can contribute to a 401(k) plan, there is significantly low limits.

What companies do is they will supersede those programs, not take a tax deduction to do it, but they will offer benefits to those executives with vesting and other components to make sure that they stay, and stay focused with that company. They will use life insurance to match that liability. They are creating a long-term liability by creating these plans for their management team. They are putting life insurance on these executives as a long-term asset so that when the benefits come due, they have the money to pay it.

So if you took that benefit away from corporations, you would have a very severe take-away from management's ability to do what is right for their management teams, for their shareholders, and so forth.

Mr. PORTMAN. Apart from what is right for the management team, and what is right in terms of retaining as you say, management employees, what would the impact be on savings? I assume many of these products you are talking about, whether it is enhancing a qualified plan, or whether it is a supplement to that, these are plans that involve saving. The life insurance is what helps to finance that longer term liability you talked about.

Mr. WAMBERG. Exactly. We would be talking in very large numbers. I do not have a specific number, but understand what we are doing, is we are taking money out of the consumption stream and we are putting it away and we are saving it for the future.

Mr. PORTMAN. Other comments on this general issue?

Mr. KIES. I think, Mr. Portman, clearly the provisions of current law that assist employers to either help save for retiree health or retiree retirement benefits both are a major plus in terms of total national savings. They facilitate the ability of employers to deliver those benefits to their employees.

In the case of retiree health benefits, if it weren't for the programs like the corporate-owned life insurance programs that help fund retiree health benefits, in many cases employers wouldn't be able to afford to provide them, and people would be looking to the Federal Government for those type of benefits. So I think they play a critical role in helping the private sector deliver a key part of those benefits.

Mr. WEINBERGER. I just have a quick point, which would be, as we look at Social Security and the problems we have with unfunded benefits there, I think that we wouldn't want to take away funding sources for retirement benefits outside the Social Security system. We would run into the same problem that we have with the Social Security system.

Mr. PORTMAN. I would hope, given the situation we are in with regard to our savings and with regard to our pension system, where only half of all workers are now covered by any kind of a pension, and beyond that, as you say, the problems we have with our public retirement system, Social Security, that proposals would come from the Congress and the administration to help companies encourage savings and encourage pensions. That would be one of my major concerns with the administration's proposals on the insurance side.

Thank you, Mr. Chairman.

Mr. KIES. Mr. Chairman, could I ask your indulgence for 1 minute? I would just like to go back to Mr. Doggett's question on my role in Social Security, because I want to make sure that I was clear.

Mr. Doggett, I have talked to probably 40 Members of Congress in the past year about Social Security issues, both Democrat and Republican, and have also been available to participate in the White House conference. So I have been available to talk to anybody who is interested in the issue. Only the Republican Members of the Congress could decide what their own plan is going to be. I just wanted to make sure I was clear that I actually have participated in a lot of discussions with——

Mr. DOGGETT. But other than attending the conference, you are not drafting the language and forwarding drafts or participating in drafting in any way?

Mr. KIES. I have actually drafted a variety of different approaches to Social Security that people have sometimes been interested in looking at.

Mr. DOGGETT. So to that extent, maybe the New York Times article is not erroneous? You are drafting provisions for a Republican plan?

Mr. KIES. No. I am not. I have drafted and shared with a variety of people different ideas. In fact, I intend to publish something soon, as a number of other people have.

Mr. PORTMAN. Mr. Chairman.

Chairman ARCHER. Who seeks recognition?

Mr. Portman.

Mr. PORTMAN. One further question, if I might just briefly. I have not had the opportunity to talk to Mr. Kies about Social Security, and I would like to go on record saying I would be delighted to. When you have time, I would like to sit down and talk to you about your ideas on Social Security. I am getting them from a broad array of people and your expertise would be most welcome.

Mr. KIES. Certainly, Mr. Portman.

Chairman ARCHER. The Chair is not sure what the gentleman from Texas is driving at. Let me make it perfectly clear that if there is a Republican plan—and I hope there will be because we certainly don't have a Democrat plan—it would be very nice to have a specific plan that will save Social Security for 75 years. Further, it will be drafted in-house, in the Congress of the United States, and it will be put in statutory language by our staff, and the normal drafting staff on Capitol Hill. So that should be very clear.

Let me ask you just a final question on tax shelters. For the benefit of the Committee, what is the definition of a tax shelter?

Mr. KIES. Well, Mr. Chairman, there are a variety of definitions. But the one that is contained in the administration proposal includes any transaction in which the reasonably expected pretax profit of the transaction is insignificant relative to the reasonably expected net tax benefit.

One of the reasons we are very concerned about that is that we believe a number of legitimate business transactions could fall within that definition. For example, a wildcat oil driller who spends $5 million, who has only a 10 percent expectation of hitting oil, under current law would clearly be permitted to deduct those expenses against his other income if he doesn't strike oil. Clearly he does not have a reasonable expectation of a net profit if he only has a 10 percent likelihood of striking oil.

Those are the kind of circumstances that we are extremely concerned about the scope of this kind of authority. It is particularly concerning because the Treasury is proposing to eliminate any reasonable basis exception where the taxpayer had reasonably relied on current law. But the definition almost becomes in the eye of the beholder if it has that kind of breadth to it.

Chairman ARCHER. Does anybody want to add anything?

Mr. Weinberger.

Mr. WEINBERGER. Quickly, Mr. Chairman. I share the same concern for the definition of tax shelter. When you look at pretax profit versus tax benefits, any kind of recapitalization of preferred stock equity for debt could be considered to be a tax shelter because there is no pretax profit, although there is clearly a business purpose for doing it.

But what I wanted to just point out is that not even all of the transactions in the President's budget that we are concerned about, including the most troublesome, the section 269 proposal, is triggered off a tax shelter. It is triggered off of tax avoidance transaction, which also is—any transaction involving the improper elimination or significant reduction of tax on economic income. That is the only definition we have right now to understand what that proposal means.

Chairman ARCHER. Under my Chairmanship of this Committee, we are going to attempt to eliminate every abuse that is being used to circumvent the clear ends of the Tax Code. But we do not want to have a net that drags in everybody, simply because we want to get some people who have abused. We have to find a way. I hope anybody who has ideas will give them to us. How we can get at the abusers without extending the long arm of the IRS into everybody's business?

It just points up to me, once again, as almost every panel and witness has pointed up to me, we will never fix the income tax. Income is such a gray area, by definition, that we will never fix it. We will keep trying and trying and trying. I hope I can win more converts to getting rid of it completely and totally, and getting to a specific form of taxation rather than a gray area form of taxation.

I thank you for your contribution. I think we will be ready now for the next panel.

Our next panel will include Michael Marvin, Delores "Dee" Thomas, Eldred Hill, Gery Chico, and Rene Bouchard. The Chair would invite all of our guests to cease chatter so we can continue with our last panel.

Our first witness will be Michael Marvin. Once again, we hope you can keep your verbal presentation to 5 minutes or less. Your entire written statement, without objection, will be included in the record, as will all of the statements for all of the witnesses on the panel.

With that, if you will identify yourself for the record, you may proceed.

STATEMENT OF MICHAEL MARVIN, EXECUTIVE DIRECTOR, BUSINESS COUNCIL FOR SUSTAINABLE ENERGY

Mr. MARVIN. Thank you, Mr. Chairman. I am Michael Marvin, the executive directive of the Business Council for Sustainable Energy. It is a pleasure to appear before this Committee to present the Council's perspective on proposed tax incentives for clean energy technologies.

The Council was created in 1992 by energy executives who were concerned about the economic, national security, and environmental ramifications of our Nation's energy policies. Our membership ranges from large multinational corporations, to smaller companies, to national trade groups. The administration has introduced tax legislation providing incentives for the purchase or development of clean energy technologies. Separately, other Members of this Committee, Mr. Matsui, Mr. Thomas, and many others have introduced some similar provisions to the administration's package.

The administration's initiative is incorporated within the so-called Climate Change Technology Initiative, which is a 5-year $3.6 billion package that addresses a range of technologies across the utility, housing, and transportation sectors. This is a modest package of incentives that moves us toward becoming a more efficient economy. I would like to highlight briefly a few incentives I believe are indicative of the goals that the administration is trying to achieve.

To encourage the purchase of efficient homes, families would receive a $1,000 to $2,000 tax credit for the purchase of homes substantially above energy code. While the administration's provision represents a strong start, we believe the legislation introduced last Congress by Representative Thomas is even more persuasive. Mr. Thomas' legislation would expand that credit to include significantly retrofitted existing homes, and make other technical changes that will make this work better in the real world marketplace. The Thomas legislation has been endorsed by organizations ranging from the National Association of Home Builders to the Alliance to Save Energy.

To promote renewable energy development, the package includes a 5-year extension of the wind and biomass production tax credit. Legislation has been sponsored by a majority of Democrats and Republicans on this Committee to continue that for 5 years. In particular, Congressmen Thomas, Matsui, and McDermott have led that charge. It provides a modest incentive for the purchase of solar rooftop power systems, and creates short-term incentives for many other energy technologies such as natural gas water heaters, heat pumps, advanced central air conditioners, and combined heat and power.

I want to underscore what I think are two important characteristics of this package. First, every provision has a cap on the maximum amount of credit a consumer could receive, usually between

$1,000 and $4,000. Second, each credit sunsets within 3 to 6 years, giving this Committee greater control over energy tax policy.

We believe these provisions make sense, whether you believe the climate is the most compelling threat to our society or whether you believe it lacks scientific merit. Regardless of climate change, there are concerns about energy independence, about local and regional air pollution, about diversification of the Nation's fuel supply, about helping U.S. business thrive in the increasingly competitive global marketplace. The fact that climate change has become so talked about in terms of energy and environmental policy does not minimize the importance of these other issues.

The Council believes that the key to greater market penetration and more effective, more efficient technologies is accelerated capital stock turnover. How do we encourage businesses and consumers to replace equipment like clothes washers, automobiles, and heat pumps, with more efficient and cleaner alternatives, when the up front costs of that equipment may be slightly higher than less efficient equipment?

Let me offer an example that is not covered by this package. Maytag recently developed a clothes washer that uses about 48 percent less water, and up to 70 percent less energy, but that machine costs more than does the average washer. By implementing a tax measure that reduces the up front cost to the consumer, a number of important objectives can be accomplished. Consumers get the value of higher efficiency equipment. Consumers save money. The environment benefits from reduced energy and water consumption. By increasing the efficiency of the products, U.S. companies stand to gain a larger share of rapidly expanding export markets.

According to the U.S. Energy Information Administration, 60 percent of the greenhouse gases that this country is expected to emit in the year 2010 will be emitted from products that have not yet been purchased. If we have to set and achieve any significant national goals of carbon emissions without command and control regulation, it is this 60 percent that this Committee can affect. Incentivizing, not requiring companies to increase efficiency, is a necessary first step.

Now it is important that we be honest here and recognize that a $700 million per year tax package in the energy world, while not insignificant, pales in comparison to the roughly $280 billion that we spend in natural gas and electricity each year. Key opportunities were missed in this package. For natural gas vehicles, other appliances, insulation, and even outdoor power equipment, short-term tax credits can help move companies in a direction that benefits consumers, the economy, and the environment. In other words, the markets for these products can be influenced by tax policy without government picking winners.

Thank you again for your time. The Council and its members want to continue working with the Committee to ensure the voice of business is heard in this debate.

[The prepared statement follows:]

Statement of Michael Marvin, Executive Director, Business Council for Sustainable Energy

The Business Council for Sustainable Energy is pleased to offer testimony to the House Ways and Means Committee on the Administration's proposed FY 2000 tax incentives to encourage the expanded use of clean energy technologies throughout the nation.

The Council was formed in 1992 and is comprised of businesses and industry trade associations which share a commitment to pursue an energy path designed to realize our nation's economic, environmental and national security goals through the rapid deployment of efficient, low-and non-polluting natural gas, energy efficiency, and renewable energy technologies. Our members range from Fortune 500 enterprises to small entrepreneurial companies, to national trade associations.

Few activities have a greater impact on our nation's economy, environment, and national security than the production and use of energy. Our economic well-being depends on energy expenditures, which account for approximately 7 to 8 percent of the nation's gross domestic product and a similar fraction of that value in U.S. and world trade. Energy production and use also account for a large share of environmental problems, such as regional smog, acid rain, and the accumulation of greenhouse gases in the atmosphere. Finally, our national security is increasingly linked to energy production and use, given our nation's increasing dependence on foreign oil sources, including those from the politically unstable Middle East.

To expand the nation's portfolio of energy resources, the Council has worked with this Administration as well as many Members of Congress to promote tax incentives for clean energy technologies. Strong leadership has come from this Committee in the past as well, including Rep. Bob Matsui, who introduced legislation similar to the Administration's Clean Energy tax package in the 105th Congress, and Rep. Bill Thomas, a long-time leader for energy efficiency in homes and renewable energy development.

In commenting on the Administration's package, the Council has identified a number of key areas that the FY 2000 budget addresses (as well as some that are not included). We urge this Committee to give the following provisions every consideration.

ENERGY EFFICIENT HOMES

Provide a Flat $2,000 Credit

The BCSE supports the adoption of a flat $2,000 credit which will ensure that all homes will be constructed or renovated to be energy efficient, not merely the most expensive models. With implementation of this credit, builders will have an incentive to construct modestly-priced, energy efficient homes and low and middle-income homeowners will be encouraged to renovate their homes with new energy efficient technologies.

Offer New Home Credit to the Home Builder

Rather than provide an incentive directly to the new home buyer, the Council supports a flat $2,000 tax credit for the new home builder, who can pass it along to the buyer at closing. A tax credit to the builder will encourage the construction of a large number of new energy efficient homes, which will expand the percentage of energy efficient homes in the marketplace, thereby stimulating additional builder and consumer interest in these dwellings. A credit for the home builder will also reduce the financial burden of using existing technology to increase energy efficiency.

Offer Existing Home Credit to the Home Owner

The Council supports a tax credit for the owner of existing homes that have been upgraded by the home owner to be 30 percent or more efficient than the IECC. To achieve a 30 percent increase in energy efficiency will require a major effort by the homeowner, and the $2,000 credit will only cover a small percentage of the marginal cost of upgrading home energy efficiency, relative to the new home credit.

Employ 1998 International Energy Conservation Code

Instead of relying on the 1993 Model Energy Code as a measure of energy efficiency, the Council supports the 1998 IECC, given this measure's accuracy in accounting for the impact of seasonal and climatic variations on energy efficiency. This reduces the likelihood that one region of the country will have an advantage in the measurement of energy efficiency. The BCSE also supports other conservation tools which use total energy efficiency analysis.

Utilize Systems of Energy Efficient Technologies

Rather than provide incentives for specific technologies within new and existing energy efficient homes, the BCSE recognizes that a wide array of energy efficient natural gas, windows, insulation, lighting, geothermal, and photovoltaic technologies can be used in concert to enable new and existing homes to be 30 percent more efficient than the IECC. Examples of energy efficient technologies which could be used to achieve the 30 percent standard could include advanced natural gas water heaters, heat pumps, furnaces and cooling equipment, fiber glass, rock wool, slag wool and polyisocyanurate insulation, energy efficient exterior windows, geothermal heat pumps, and fluorescent and outdoor solar lighting.

ENERGY EFFICIENT BUILDING EQUIPMENT

The BCSE is pleased with the Administration's proposal which provides a 20 percent tax credit for fuel cells, natural gas heat pumps, high efficiency central air conditioners, and advanced natural gas water heaters (subject to a cap). However, the Council recognizes the need for incentives for energy efficient building technologies to be broadened for the benefit of consumers and the environment. The BCSE recommends consideration of a 20 percent tax credit for advanced natural gas water heaters with an energy factor (EF) of .65, a 20 percent tax credit for natural gas cooling equipment with a coefficient of performance of .6, and a 20 percent tax credit for advanced natural gas furnaces with an annual fuel utilization efficiency of 95 percent. Given the significant reduction in greenhouse gas emissions which can be achieved through the expanded use of small-scale distributed generation technologies, the BCSE supports a 20 percent tax credit for all fuel cells, regardless of their minimum generating capacity. Other technologies which could be included in a broadened tax incentive package include variable frequency drives and motors, building automation systems, and compressed air systems.

ALTERNATIVE FUEL VEHICLES

While the BCSE recognizes the Administration's efforts to provide tax incentives to encourage consumer demand for vehicles with two and three times the base fuel economy of vehicles on the road today, we are concerned that it has not provided an incentive for natural gas vehicle (NGV) technology. While NGVs are more expensive than gasoline and diesel vehicles, these technologies reduce CO_2 emissions by 30 percent below that of gasoline vehicles currently on the road. The BCSE supports a 50 cent per gallon income tax credit for each "gasoline gallon equivalent" of compressed natural gas, liquified natural gas, liquified petroleum gas, and any liquid with at least 85 percent methanol content used in a newly purchased alternative-fueled vehicle which meets applicable federal or state emissions standards. These tax incentives will increase demand for clean fuel vehicles, especially in fleet markets, accelerate production of NGVs, and lower the initial purchase cost of the technology.

WIND ENERGY

The BCSE supports the Administration's proposal to provide a straight 5-year extension (through July 1, 2004) of the existing wind energy production tax credit (PTC) provision providing a 1.5 cent per kilowatt hour tax credit (adjusted for inflation) for electricity generated by wind energy. An extension of the current credit prior to its expiration on June 30, 1999 will stimulate investments and current project planning that are now threatened due to the uncertainty surrounding the PTC's extension. In addition to the Administration's proposal, legislation was introduced during the 105th Congress (H.R. 1401/S. 1459) to provide a 5 year extension for the wind energy PTC. The Council also supports a 30 percent tax credit for small wind turbines with generating capacities of 50 kilowatts or less. (H.R. 2902) which was introduced during the 105th Congress. The goal of the new program is to stimulate the U.S. domestic market, increase production volumes and reduce production costs. Growing export markets for small wind turbines provide effective leverage of the federal investment in job creation.

BIOMASS

The BCSE supports the expansion of the biomass energy PTC from its current "closed loop" definition to include a 1.5 cent per kilowatt hour tax credit for electricity produced from landfill gas, wood waste, agricultural residue, and municipal solid waste. In addition to offsetting greenhouse gas emissions, the use of biomass energy can address problems of landfill overcapacity, forest fires, and watershed contamination.

Combined Heat and Power Systems

The following points should be added to the Administration's proposed investment tax credit for combined heat and power systems.

"The proposed definition of a qualified CHP system in the Administration's proposal is equipment used in the simultaneous or sequential production of electricity, thermal energy (including heating and cooling and/or mechanical power) and mechanical power."

Language in the current proposal could be construed to limit the credit solely to those taxpayers that produce mechanical power in conjunction with electric or thermal energy production. In addition, specificity is needed as to what "equipment" is included in the CHP definition. A better definition of a qualified CHP system is: equipment and related facilities used in the sequential production of electricity and/or mechanical power and thermal energy (including heating and cooling). Eligible equipment shall include all necessary and integral to the CHP process including prime movers (turbines, engines, boilers), heat recovery boilers, air and water filtration, pollution and noise control, and paralleling switchgear but may exclude buildings, fuel handling and storage and electrical transmission."

Items such as thermal insulation, controls, and steam traps should be included within tax incentives for CHP systems. Tax credits instituted from a systems standpoint will enhance the overall efficiency of CHP technologies.

BCSE supports the addition of language concerning thermal distributing networks to the CHP investment tax credit:

Distribution piping used to transport thermal energy including steam, hot water and/or chilled water as well as condensate return systems shall be included as part of a qualifying CHP system. Thermal distribution systems added to existing electricity-only energy facilities which then meet the definition of CHP facilities shall be eligible for the tax credit.

Furthermore, the BCSE supports the addition of the following language concerning backpressure steam turbines to the CHP investment tax credit:

"Backpressure steam turbines can be highly efficient generators of electricity and thermal energy. When used in distributed thermal energy systems to replace pressure reducing valves these turbines convert higher pressure thermal energy into lower pressure thermal energy along with electricity. Backpressure steam turbines with a capacity of between 50 kw and 3000 kw that reduce steam pressure and generate electricity qualify for the CHP Investment Tax Credit.

White Good Appliances

The BCSE supports a 25 percent tax credit for the purchase of Energy-Star®-certified white good appliances. Such a credit would give consumers an incentive to purchase the highest efficiency appliances, expanding the market for the technologies, and encouraging the manufacturer participation in this voluntary program. At a minimum, the Council would urge the Administration to adopt credits for the most energy efficient clothes washers and refrigerators which are in the market today.

Residential Biomass

Fuel pellets are a residential biomass technology used to heat residences throughout the U.S. The BCSE supports a 15 percent tax credit for fuel pellets used for residential home heaters and a 20 percent tax credit for fuel pellets used in residential and commercial water heaters, a market which is not as mature as the market for residential home heaters.

Research and Experimentation

The BCSE supports a permanent extension of the research and experimentation (R&E) tax credit. In response to a request by Council member Gas Research Institute, the Policy Economics Group of KPMG Peat Marwick examined the most recent economic evidence and official IRS statistical information to determine whether a permanent extension of the R&E tax credit was warranted. Conclusions were that the credit's effectiveness warranted a permanent extension, which may improve its effectiveness. The current short-term approach to subsidizing long-lasting research and development investments imposes unnecessary additional risks on R&D-per-

forming companies, and does not best serve the country's long-term economic interests.

RESIDENTIAL SOLAR TECHNOLOGIES

The BCSE supports a tax credit equal to 15 percent of a qualified investment for neighborhood solar systems which enable energy consumers within multifamily dwellings, rented housing, and homes with roofs not suitable for direct photovoltaic (PV) installation to heat and cool their homes. The inclusion of tax incentives for neighborhood solar systems will reduce the cost of these investments while reducing overall greenhouse gas emissions. The Council also recommends a flat $400 credit for residential solar water heating or space heating systems certified by the Solar Rating and Certification Corporation or comparable agency. The credit could be added to the Administration's hot water efficiency credit. The BCSE also supports a $100 tax credit for pool heaters for family households with income under $85,000 or single households with income under $65,000.

CLEAN AND FUEL EFFICIENT OUTDOOR POWER AND LIGHTING EQUIPMENT

BCSE supports a tax credit for the purchase of clean and fuel efficient outdoor power and lighting equipment used in residential, commercial, and industrial applications. The credit would equal 10 percent of the purchase price of outdoor power and lighting equipment. Outdoor power equipment that meets Environmental Protection Agency Tier II emissions standards prior to their implementation or effective dates would be eligible for this tax credit. The creation of an analogous tax credit for manufacturers of these technologies could also result in substantial fuel savings and other environmental benefits.

CONCLUSION

The Council recognizes the leadership this Committee has shown in the past to promote incentives for clean energy technologies as well as the positive impact these provisions have had on our nation's economy, environment, and national security. We pledge to continue working with the Committee, the Congress, and the Administration to pursue comprehensive initiatives which will accelerate new developments in the way we produce, generate, and consume energy. Many of us in the business community are willing to stand behind comprehensive clean energy tax incentive proposals and those who support them.

Note: Where appropriate, the BCSE identifies legislation that was introduced in the 105th Congress which includes similar or identical language to that recommended here.

Chairman ARCHER. Thank you, Mr. Marvin.

Ms. Thomas, if you will identify yourself for the record, you may proceed.

Mrs. THURMAN. Mr. Chairman

Chairman ARCHER. Certainly, Mrs. Thurman.

Mrs. THURMAN. Thank you. Mr. Chairman, I actually would like to take an opportunity here to thank Ms. Thomas for being here. She actually is one of my constituents.

Chairman ARCHER. I suspected that when you asked to be recognized.

Mrs. THURMAN. Yes. I kind of thought you might. I want you to know that she runs a 100-percent, employee-owned business. She has been very active. She is going to be the first woman to be the national president of the ESOP group. I think you are going to find her testimony dynamic, informative, and one that, as we heard the administration say this morning, for all of you actually that are sitting there, that they are listening and paying attention. So I just wanted to have this opportunity.

I am really glad you are here, particularly when it's sunny and warm in Florida.

Chairman ARCHER. We are happy to have you here. If you will identify yourself for the record, you may proceed.

STATEMENT OF DELORES L. "DEE" THOMAS, VICE PRESIDENT, EWING & THOMAS, INC., NEW PORT RICHEY, AND SEBRING, FLORIDA, AND VICE CHAIR, EMPLOYEE STOCK OWNERSHIP PLANS ASSOCIATION

Ms. THOMAS. Thank you, Chairman Archer. Thank you ladies and gentlemen, for the opportunity to speak with you today. My name is Dee Thomas. I am vice president of an independent physical therapy company located in New Port Richey and Sebring, Florida. Important for today's hearing is the fact that Ewing & Thomas is the only 100-percent, employee-owned physical therapy company in America through an ESOP, an employee stock ownership plan, and that is a sub S. Of our 45 employees, 38 are employee-owners, owning 100 percent of our company. I testify today on behalf of those employee-owners, and on behalf of the ESOP Association. It has over 2,000 members representing 1 million employee-owners in America.

My purpose here today is to express my concern and opposition to the administration's proposal to repeal the 1997 law which was designed to encourage the creation of employee-ownership in S corporations, and in particular, those with high percentage ESOPs, such as my own company.

Ewing & Thomas provides physical therapy services to a community in the second poorest district in Florida. Our industry is becoming increasingly controlled by large companies and megaconglomerates. Many of the small independents are either being sold or going out of business as a result of changes in the healthcare laws. The conscience of American healthcare is becoming an extinct species.

I am convinced that Ewing & Thomas continues to survive in this ever-competitive environment because of our employee-ownership culture and the current single tax status as a sub S ESOP. ESOP transactions have cost our little company great amounts of money because the ESOP laws are complex and we require a lot of lawyers and administrators to keep us straight and make sure that our employee-owners are all well protected.

But ESOPs are more than laws and regulations. They are a way of life at Ewing & Thomas. We have employee-owners on all levels at our six-member board of directors. We have participation in decisionmaking at all levels with our ESOP Committee. We share and discuss all of our financial information. Our little company has paid for 10 needy employee-owners to go to college so that they can be better employee-owners and they can better our company.

Each day, incredible unselfish acts are performed by this group of uncommon employee-owners. This past year during tough times, our higher paid salaries unanimously agreed to take a freeze on all of their wages and benefits so that our nonmanagement hourly people would not be laid off and would not lose their jobs. This is employee-ownership at its best. We are in this for the long haul.

Your esteemed colleague, Congresswoman Karen Thurman, has visited our company and met with our employee-owners first hand. You can also take a minute and speak with Al Maxime and Gary Walz, who have traveled with me today. They each have their own special employee-ownership story.

This Committee has to make a basic choice because this issue is not just about sub S ESOPs, but about your belief in the value of employee-ownership in America. You can reject the administration's proposal or you can modify it, and in so doing, stand with employee ownership. Or you can accept the proposal and in doing so, repudiate support for employee ownership, a message that will be heard by 1 million employee-owners and 2.2 million sub S companies in this country.

In simple language, my objections are: the retroactive clause applied to companies such as mine because our account balances would fall sharply. Number two, it is not rational to reverse something that is only 14 months old. Number three, the proposal is incredibly complex. What a bunch of gobbley-goop. No businessperson in their right mind would go into some kind of deal like this. The proposal by permitting a tax deduction for distribution for the ESOP against the UBIT is an incentive for the corporation to make distributions as rapidly as possible. This is not a sound way of saving.

The proposal puts the S corporation with an ESOP at a distinct disadvantage to the C corporation with the ESOP. The S corporation will pay a much higher tax and without any ESOP incentive. This is a much bigger issue than the tax consequences of a sub S ESOP. It is about your stand for employee-ownership in America. It is about your belief in increasing the distribution of wealth in our country. It is about workers having a voice, respect, and dignity in the place that they work, and security for their retirement years. The 100-percent, sub S ESOP companies are the best this country has to offer. We have done all the right things for all the right reasons, our employee-owners.

Members of this Committee, we ask for your protection from this proposal. We are prepared to work with you and your staff to ensure the multitude of sub S companies the promise of employee-ownership. I urge you to allow us to work together to spread employee-ownership as a commonly accepted way of doing business as we enter the next century. I thank you all for letting this small company be heard. It's a great system that we have.

[The prepared statement follows. Attachments are being retained in the Committee files.]

Statement of Delores L. "Dee" Thomas, Vice President, Ewing & Thomas, Inc., New Port Richey, and Sebring, Florida, and Vice Chair, Employee Stock Ownership Plans Association

Thank you. My name is Delores L. "Dee" Thomas. I am Vice President of an independent physical therapy company, Ewing & Thomas, Inc. located in New Port Richey and Sebring, Florida.

Important for today's hearing is the fact that Ewing & Thomas is the only physical therapy company in America operating as a 100% employee-owned company, through an employee stock ownership plan, or ESOP. Ewing & Thomas is also an S corporation. There are 38 employee owners at Ewing & Thomas, which is nearly all of our current employees.

Today, I testify not only on behalf of the employee owners of Ewing & Thomas, but also for The ESOP Association, a national 501(c)(6) association with over 2000 members representing nearly1 million employee owners.

My purpose is to express the ESOP community's opposition to the revenue raising proposal in the Administration's proposed budget to repeal a 1997 law that has proven to be a needed incentive for the creation and operation of companies which are 100%, or near 100% employee-owned companies. The proposal is set forth on page 110 of the Treasury Department's so-called "Green Book" describing the Administration's revenue raising proposals in the Fiscal Year 2000 budget.

I ask your indulgence as I make a few general remarks. I do so because in the employee ownership world our focus is on the long-term, not the short-term.

We believe that significant employee ownership does improve the performance of a corporation, and just as important does maximize human potential and self-dignity of all employees as they share in the wealth they help to create.

Our beliefs are backed-up by solid evidence, such as a recent study by Dr. Melhad of Northwestern University's Kellogg of Business and Management, which reviewed the performance of over 400 companies over 4 years. Attachment 1 to this statement is a synopsis of the research conducted over the past 15 years that supports our beliefs.

I am very active in The ESOP Association, nationally, and in our Florida Chapter. On May 1, I will become the Chair of the Association, our highest elected office.

But clearly I can testify best about employee ownership through the experience as an executive of Ewing & Thomas.

In 1987, Mrs. Ewing and I, who started our independent firm in 1969, faced the potential demise of our company, as Mrs. Ewing had reached an age where she did not want to practice each day, and I had a serious illness. We needed an exit strategy, but were afraid of what would happen to our employees and our community involvement if we sold out to a large national or regional chain. Fortunately, Congress has provided a wonderful alternative—selling to the ESOP for the benefit of the employees.

Did we take advantage of the tax laws favoring exiting shareholders of closely-held companies? Yes, we did. Did we have to pay high fees to lawyers, valuators, administrators, and accountants to make the ESOP happen, so that the complex ESOP laws would be honored to protect the employees? Yes, we did.

But let me emphasize, the ESOP is more than laws and regulations to our employees. It has become their way of life.

For example:

- We have employee owners from all levels on our six-person Board of Directors.
- We have employee owners participating in decision-making at all levels.
- We share and discuss all of our financial information with all employee owners.
- It was a joint decision that our company has sent ten needy employee owners to college to better themselves and our company.
- Each day incredible unselfish acts are performed by this group of employee owners.
- We all participate in state and local meetings where we share our ESOP experience and learn from other employee-owned companies.

Attachments 2 are articles recognizing Ewing & Thomas as a special place to work.

If you do not believe me, or the articles, ask your colleague Congresswoman Thurman, who has visited on several occasions with our employee owners.

And if you don't believe me, Congresswoman Thurman, or the newspapers, ask Alphonso Maxime or Gary Walz, employee owners from Ewing & Thomas now standing. They will be more than willing to speak with you or your staff about employee ownership, and their experience at Ewing & Thomas.

Is Ewing & Thomas unique? No.

When I think of employee ownership I think of Bimba Manufacturing in Illinois; Reflexite in Connecticut; Austin Industries in Texas; Acadian Ambulance in Louisiana; the Braas Company in Minnesota; and the list goes on and on.

Many members of this Committee know these companies and their employee owners up close and personal.

This Committee has a basic choice.

The Committee can accept the Administration's proposal, and take a stand to retard the expansion of employee ownership; or this Committee can reject, or significantly alter the Administration's proposal, and take a stand with the employee ownership community.

Clearly, we must respond to the specific proposal from the Administration, and explain why its enactment would retard employee ownership growth; but keep in mind, if you want employee ownership to grow, as practiced in the companies I've cited, then you will discard the Administration's proposal.

To summarize the Administration's proposal: The proposal is designed to raise taxes by imposing on an S corporation an unrelated business income tax, or UBIT, on the ESOP's share of the income of that corporation. The proposal goes on to provide that when the ESOP makes a distribution to an employee owner when he or she retires or leaves the company, the S corporation can take a tax deduction against the UBIT owed for the year in which the distribution is made.

The proposal's effective date is meaningless as it is to apply to all S corporation ESOPs after enactment, and is to lower the tax deduction for distributions made by those companies who did not pay the UBIT between January 1, 1998, and the date when the new law is effective.

Contrast this proposal with current law, which was adopted by Congress, and signed by President Clinton approximately fourteen months before the Administration proposed the drastic change summarized above. Current law provides that the ESOP's share of the S corporation's taxable income is deferred from current taxation until the ESOP makes distributions to the ESOP participants, who are in essence the shareholders of the S corporation.

To understand the Administration's proposal fully requires some history.

Shortly after the enactment of the Tax Reform Act of 1986, the ESOP community urged Congress to enact law to permit S corporations to sponsor employee ownership through ESOPs.

Our efforts gained momentum in 1990 when your colleague Congressman Cass Ballenger introduced the ESOP Promotion Act of 1990, which contained a section to permit ESOPs in S corporations. Similar legislation was introduced in each subsequent Congress, twice attracting over 100 co-sponsors. Each time, eight to ten members of the Ways and Means Committee were original co-sponsors of these pro-employee ownership bills.

In 1996, our advocacy work began to payoff, as the Congress adopted a provision of the Small Business Jobs Protection Act of 1996, a law to permit an S corporations to sponsor an ESOP.

Immediately, however, all realized that the 1996 law was fatally flawed. The major policy problem was the 1996 law was going to tax S corporation income twice if it had an ESOP, because it would have imposed the UBIT on the ESOP's share of the S corporation's taxable income, and a tax on the individuals receiving ESOP distributions.

Groups led by representatives of S corporation groups urged the members of the tax committees to undo the double tax on the ESOP's share of the S corporation's income.

And, at the same time, the ESOP community urged Congress to provide S corporations the same tax benefits for promoting employee ownership as available for C corporations, such as the deferral of the capital gains tax on the proceeds of sales of closely held stock to an ESOP under limited circumstances, deductible dividends paid on ESOP stock in certain circumstances, and the increase in the corporate tax deduction for contributions to an ESOP up to 25% of payroll, plus the interest on the loan used to acquire stock for the employees through an ESOP.

So, as the work on the 1997 law known as the Taxpayer's Relief Act began, these points were being made to Congresspeople supportive of increasing employee ownership in America.

First, in early summer 1997, this Committee adopted by voice vote Congresswoman Johnson's amendment to clean up some of the technical problems with the 1996 law.

Then the Senate Finance Committee had to decide—how to encourage ESOPs in S corporations? Their decision was not to use the C corporation ESOP tax benefits in an S corporation, but to have a unique benefit, the deferral of tax on the ESOP's share of the corporation's taxable income until distributions to the employee owners.

In making this decision, the Senate staff people did review a taxation scheme very similar to the one proposed in the Administration's Fiscal Year 2000 budget. It involved paying the UBIT on the ESOP's share of the S corporation's income, and then later providing a tax credit or tax deduction. But this scheme was rejected. The staff agreed that it was too confusing. They felt that the system would never be clearly understood, or work in the real world.

How ironic that now the Administration makes a similar proposal, which was deemed too complex in 1997!

In any event, the result in 1997 was a decision not to have the C corporation ESOP tax benefits available to an S corporation ESOP but to have the ESOP share of the taxable income of the S corporation subject to a deferred taxation when the beneficial shareholders of the S corporation, the employees got their money from the ESOP.

A key point in all of this decision making is the clear-cut intent of the Senate to have an incentive for the creation and operation of ESOPs in S corporations. In fact, the proposal was scored as a near $400 million revenue drop over the 10 year period of the revenue estimates for the 1997 Taxpayer's Tax Relief Act.

When this approach was proposed by ESOP supporters in the Senate, the ESOP community told key Congressional leaders that this approach was unique, and felt it to be a powerful incentive for the creation of 100% ESOP companies or near 100% ESOP companies operating S corporations.

We were correct. Since the law became effective January 1, 1998, we estimate approximately 75 to 100 of our Association's members have become 100% employee-owned S corporations through an ESOP. Some of these companies increased their employee ownership of their owner's share from less than 100% to 100%.

Clearly in our minds this was the intent—the incentive of the law to increase the distribution of wealth in America.

Is this a good policy? If you support employee ownership, the question becomes is it good employee ownership policy?

Yes, if Congress wishes to have an incentive for 100% or near 100% employee ownership—a level of employee ownership that is rare in America, less than 500 companies, but a level that can be magical in creating an company culture where voices are heard and votes do count—a company like Ewing & Thomas.

Why do large ESOPs, as measured by the size of the company owned by the employees need an incentive that is different from the C corporation ESOPs? Because the 100% ESOP company must have significant cash values as it reaches maturity—5, 10, 15, 20, or more years of employee ownership in order to buy back the stock from departing employees with large accounts in the ESOP. We call this burden on ESOP companies our repurchase obligation, or repurchase liability. Obviously, the bigger share of the company owned by employees through the ESOP, and the older the ESOP becomes, the more money the company has to have to buy back stock from departing employee owners.

All too often we see fine examples of ESOP companies, where employees are sharing substantially in the wealth they help create, abandon employee ownership due to this repurchase obligation issue, and the demands on cash. I cite AVIS and reference Attachment 3.

The one level of tax on a 100% S corporation ESOP solves this problem due to the fact that the cash saved may be used to fund the repurchase of stock from departing employees.

Finally, I cite the objections of The ESOP Association to the Administration's proposal.

Objection One: By being retroactive, by applying to companies like mine that honestly relied on the law passed by Congress, and signed the by the President just fourteen months ago, the proposal pulls the rug out from under the employee owners of my company and others like us.

Those in the Administration who came up with this proposal might think we were naive to believe that the law was for the benefit of companies like ours. Maybe they are laughing behind their backs at us. We may be naive, and not sophisticated to the cleaver nuances of how tax laws are made; but we do know when we are being treated unfairly, and we don't like it.

Objection Two: It is not rational to reverse the 1997 decision to encourage more employee ownership only fourteen months after the decision was made. As representatives of The ESOP Association told key Congressional decisionmakers in 1997, providing a deferral of the tax of the ESOP's share of the S corporation's taxable income would be a significant incentive to be a 100% ESOP company, like Ewing & Thomas believed. The law has worked just as predicted. Why get rid of this incentive?

Objection Three: The Administration's proposal is, in essence, the same, impossible to administer scheme the Congressional staff experts declared incredibly complex in 1997. My non-legal description of the proposal is as follows: The S corporations with an ESOP loans the Federal government money equal to the UBIT tax. Then, 5, 10, 15, 20, or even more years down the road, the Federal government pays back the loan in drips and drabs, in amounts related to distributions of ESOP accounts that will not have any relationship whatsoever to the amount of the UBIT paid in any one year.

Objection Four: The proposal, by permitting a tax deduction for distributions from the ESOP against the current year UBIT owed by the S corporation is an incentive for the corporations to make distributions as rapidly as possible, or timed to profitable years. Thus the proposal is an incentive that is absolutely the opposite of good savings policy, where we want to keep in the money in the savings systems for retirement income security.

Objection Five: The Administration's proposal puts the S corporation with an ESOP at a distinct disadvantage compared to a C corporation ESOP. If the proposal is the law, the S corporation ESOP, particularly those with 100% employee ownership, pays more taxes than C corporations, and have none of the special ESOP tax benefits, such as the ability of certain sellers to an ESOP to deferred the capital gains tax, deductible dividends paid on ESOP stock, and the higher percentage of payroll that can be contributed to a leveraged ESOP. These three are all available to the C corporation, but not the S corporation.

This is a much bigger issue than the tax consequences of S Corporation ESOPs. It is about your stand for employee ownership in America. It is about your belief in increasing the distribution of wealth in this country, about workers having a voice, respect and dignity in the place that they work and security for their retirement years.

The 100% S Corporation ESOP companies are the best this country has to offer—we have done all the right things, for all the right reasons—employee owners!

Members of this committee we ask for your protection from this proposal. We are prepared to work with you and your staff to assure the multitude of S Corporation companies can meet the promise of employee ownership.

I urge you to allow us to work together to spread employee ownership as a commonly accepted way of doing business as we enter the next century.

Thank you for allowing this small company to be heard.

Chairman ARCHER. Ms. Thomas, that is what we are about, to hear from people large and small and across the board. Thank you for your testimony.

Mr. Hill, if you will identify yourself for the record, you may proceed.

STATEMENT OF J. ELDRED HILL III, PRESIDENT, UNEMPLOYMENT INSURANCE INSTITUTE, SHEPHERDSTOWN, WEST VIRGINIA

Mr. HILL. Yes, thank you, Mr. Chairman. My name is J. Eldred Hill III. I am the president of the Unemployment Insurance Institute. I thank you for this opportunity to testify regarding tax proposals in the President's fiscal year 2000 budget, affecting the Nation's unemployment insurance system.

The President's budget contains a proposal to accelerate the collections of FUTA, Federal Unemployment Tax Act of 1939, and State UI, Unemployment Insurance, taxes from quarterly to monthly beginning in the year 2005. It would require every employer whose FUTA liability in the immediately preceding year was $1,100 or more to compute and pay both FUTA and State UI taxes 12 times a year. Although this proposal in theory would only affect businesses not classified as small under Federal law, in practice, this proposal would also affect small businesses which rely primarily on part-time workers, small employers experiencing employee turnover beyond their control, and small employers who provide summer jobs for youth.

This proposal, quite frankly, is a budget gimmick, which would allow the administration to count two extra months of FUTA collections as fiscal year 2005 revenue, producing a one-time artificial budget gain of an estimated $1.2 billion. Accelerated collections would not raise a nickel in new revenue. Monthly collections would triple the paperwork and other employer compliance costs forever. In addition, it would triple the collection workload on the State employment security agencies, increasing costs, and taking precious staff time away from their primary responsibilities, of providing the unemployed with benefits and jobs.

Mr. Chairman, unemployment contributes to a number of social ills, including depression, alcohol and drug abuse, domestic violence, repossessions, foreclosures, and evictions. These real-world costs are not on a budget line. Yet under the President's proposal, the Nation's unemployed could expect reduced services as limited staff resources are used for more frequent collections.

The President's budget also contains proposals which would charge new fees to employers who request certification under both the Work Opportunity Tax Credit, and the Welfare-to-Work Tax Credit. Both of these Federal programs were designed to encourage employers to hire targeted workers, and it would be counterproductive to reduce those incentives.

We have heard a good bit today here about fees that are included in the President's budget. Though these fees are innocuous on the surface, certification costs are incidental to these fees. The new fees are designed to be artificially high and the additional revenue generated would be used for the administration of the unemployment insurance system and the employment service. These fees would be collected and spent at the State level. The President's budget projects these fees to generate $20 million per year, and upon enactment would cut Federal appropriations for the administration of State UI and ES programs by a corresponding $20 million.

These new fees are in effect a new FUTA surcharge. The Nation's employers are already paying FUTA taxes which are more than adequate to fund the administration of the UI and ES systems. In 1997, Congress passed the Taxpayer Relief Act, extending the unnecessary and so-called temporary 0.2 FUTA surcharge for 9 years.

According to the President's budget, the Federal administrative account, extended benefit account, and loan account, will have combined statutory excesses of $5.68 billion in fiscal year 2003, and $3.93 billion in fiscal year 2004. Still, States on average see only 52 percent of dedicated FUTA taxes returned for the administration of these programs. Employers in 20 States also pay an additional State administrative surcharge, which diverts revenues from the benefit funds.

Mr. Chairman, in an era when we are engaged in public debate over the budget surplus, it would be unfair for Congress to allow employers to be further burdened with new, unneeded FUTA surcharges or monthly collection.

Mr. Chairman, I appreciate this opportunity to appear before the Committee. I would be happy to answer any questions you or your colleagues may have. Thank you.

[The prepared statement follows:]

Statement of J. Eldred Hill III, President, Unemployment Insurance Institute, Shepherdstown, West Virginia

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify regarding the tax proposals in the President's FY 2000 budget affecting the nation's unemployment insurance system.

The President's FY 2000 budget contains a proposal to accelerate collections of FUTA and state UI taxes from quarterly to monthly beginning in 2005. It would require every employer who's FUTA liability in the immediately preceding year was

$1,100 or more to compute and pay both FUTA and state UI taxes 12 times a year. Although this proposal in theory would only affect businesses not classified as "small" under federal law; in practice this proposal would also affect small businesses which rely primarily on part-time workers, small employers experiencing employee turnover beyond their control, and small employers who provide summer jobs for youth.

This proposal is a budget gimmick which would allow the Administration to count 2 extra months of FUTA collections as FY 2005 revenue, producing a one time artificial budget gain of an estimated $1.2 billion. Accelerated collections would not raise a nickel in new revenue.

Monthly collections would triple the paperwork and other employer compliance costs *forever*. In addition it would triple the collection workload on the State Employment Security Agencies, increasing costs, and taking precious staff time away from their primary responsibilities of providing the unemployed with benefits and jobs. Unemployment contributes to a number of social ills, including depression, alcohol and drug abuse, domestic violence, repossessions, foreclosures, and evictions. These real world costs are not on a budget line, yet under the President's proposal, the nation's unemployed could expect reduced services as limited staff resources are used for more frequent collections.

The President's budget also contains proposals which would charge new fees to employers who request certification under the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit. Both of these federal programs were designed to encourage employers to hire targeted workers, and it would be counterproductive to reduce those incentives. The proposal also includes similar fees for employers of alien workers. Though innocuous on the surface, certification costs are incidental to these fees. The new fees are designed to be artificially high, and the additional revenue generated would be used for administration of unemployment insurance (UI) and the employment service (ES). These fees would be collected and spent at the state level. The President's budget projects these fees to generate $20 million per year, and upon enactment would cut federal appropriations for the administration of state UI and ES programs by a corresponding $20 million.

These new "fees" are in effect a new FUTA surcharge. The nation's employers are already paying FUTA taxes which are more than adequate to fund the administration of the UI and ES systems. In 1997 Congress passed The Taxpayer Relief Act extending the unnecessary 0.2% FUTA Surcharge for nine years. According to the President's budget, the federal administrative account (ESAA), extended benefit account (EUCA), and loan account (FUA) will have statutory excesses of $5.68 billion in FY 2003 and $3.93 billion in FY 2004. Still, states on average see only 52% of dedicated FUTA taxes returned for the administration of these programs. Employers in 20 states also pay an additional state administrative surcharge which diverts revenues from benefit funds. Mr. Chairman, in an era when we are engaged in public debate over the budget surplus, it would be unfair for Congress to allow employers to be further burdened with new unneeded FUTA charges or monthly taxation.

Mr. Chairman, I appreciate this opportunity to appear before this committee. I would be happy to answer any questions you or your colleagues might have.

Chairman ARCHER. Thank you, Mr. Hill.

I am told that our next witness is to be introduced by one of our colleagues, the gentleman from Illinois, Mr. Blagojevich.

Mr. BLAGOJEVICH. Thank you very much, Mr. Chairman. I will be very brief.

A little over 10 years ago, Bill Bennett, who was then the Secretary of Education under President Reagan, came to Chicago and declared our school system the worst school system in the country. A little over 10 years later, under the leadership of our mayor, Mayor Daley, and under the leadership of our president of the Chicago School Reform board of trustees, Gery Chico, the Chicago public schools' success at school reform is being held as a national model, and most recently was spoken of by President Clinton in his State of the Union Address.

As a product of the public schools, I am proud today to introduce the chief executive officer of the Chicago public schools, Gery Chico, and let him tell this Committee about some of the innovative things that the school board has performed in our city and for our schools over the last 3 to 5 years. Gery?

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Congressman Blagojevich.

Mr. Chico, you have already been identified for the record, so you may proceed.

STATEMENT OF GERY CHICO, PRESIDENT, CHICAGO SCHOOL REFORM BOARD OF TRUSTEES

Mr. CHICO. Thank you, Mr. Chairman. I would like to thank you for the opportunity to speak about an issue that is near and dear to my heart and a lot of people in Chicago, and that is the need to rebuild our school facilities. I would like to thank Speaker Hastert and Congressman Rangel, who we had the pleasure of meeting with this morning as a courtesy call to explain our positions, and now to give the Committee our position on this issue.

Since 1995, Chicago has committed nearly $2 billion from local funds to improve our school facilities. We are doing our part, but we think we need partners at the Federal level to help us meet the continuing need, Mr. Chairman, which conservatively is put at about another $1.5 billion just for Chicago alone. The fact is, improving the learning environment improves performance. A litany of studies shows that, although I don't think you need studies to know that.

When kids are in overcrowded classrooms, or taking class in hallways and basements, they figure school isn't important. In 1998, the report card on America's infrastructure, issued by the American Society of Civil Engineers, Mr. Chairman, gave schools an "F", being the only category of infrastructure with an "F" rating. Roads, bridges, mass transit, aviation, and others came in substantially higher. We can't afford to send that message to our children.

In thinking about the proposals before the Committee I want to emphasize what I think are four basic characteristics that any plan that the Committee would adopt should have, so that we can get the help we need. One, simplicity. Two, flexibility. Three, the plan ought to be substantial. Four, we need immediate help.

If it is not a simple plan, it creates a lot of paperwork which eats up time and money. If it is not flexible, it will dictate terms rather than support us, and that is not appropriate in our view. If it is not substantial, it is really not very relevant. There is an estimated $200 billion in school infrastructure needs nationwide. We need a real commitment, not token help. If it's not immediate, it is also not very relevant to us because every year we delay, it deprives our children of the education that we think they need and that we think that they need today.

Before the Committee are two proposals. One plan has an arbitrate component, that allows school districts to borrow money and invest it for up to 4 years now instead of 2 years, and use the extra interest earned toward school construction or improvements. Our concerns are that this plan does not provide enough money to make an impact, at least in Chicago's view, nor does it provide the money right away.

In Chicago, we have issued four bond issues over the last 4 years to create that $2 billion. Only one of those four bond issues would we have seen a positive arbitrage of one-tenth of 1 percent. In fact, the last bond issue that we saw just 2 weeks ago, we pay an interest rate of 5.17 percent and reinvest at 4.85 percent, for negative arbitrage. It also doesn't work for Chicago because we spend our money as soon as we get it, Mr. Chairman. We can not afford the luxury of waiting 1 year, 2 years, or 3 years because people expect us to act and act quickly.

The other plan advanced by the Clinton administration and Vice President Gore and Congressman Rangel creates new school modernization bonds, both of which rely on tax credits. It will offer up to $25 billion in bonding authority to school districts around the country. From our standpoint, this is a solid plan for the reason that it provides us substantial relief. In the case of Chicago, we figure that we could issue $670 million in bonds and save $333 million in interest payments. We think that is real help.

The Federal Government would even be more effective if they would extend the payback period beyond the proposed 15 years in the proposal before the Committee because the principle-only payment for such a short term of 15 years is virtually the same or close to the payments of principle and interest over 30 years.

The plan also calls for the Department of Education to sign off on individual capital plans. We think, however, that the Department's role should be limited to receiving descriptions of capital plans and annual reports, and nothing more.

Unlike the school modernization bonds, the use of the qualified zone academy bonds requires a substantial business contribution. Unless Congress adjusts the proposal, to offer business a significant incentive to make this investment, many smaller local school districts won't be able to access the program. For example, we are using this qualified academy zone bond now for the second time. We have had to pull in five surrounding districts to Chicago: Elgin, Aurora, DeKalb, Mendota, and East St. Louis, to help them access this bond issue, because otherwise they can't come up with the local private sector match of 10 percent. It is just too much for those districts.

We understand there is also a plan in front of the Senate to enable private investors to fund school construction by offering investors significant depreciation incentives along with favorable tax-exempt financing. This concept works only if the buildings remain free from real property taxation at the local level. Congress should allow the school districts to maintain title and allow the tax benefit to go to the private investor if it goes down this road.

I have offered more detailed explanation of our observations here in my written testimony. In the space of 5 minutes, I don't think we can—I won't revisit the philosophical debate over whether the Federal Government has a role to help us in education, but I will just repeat what I said 6 weeks ago in front of Chairman Goodling's Committee. That is, I think we need to make school construction a national priority. We simply can't do it by ourselves any more. We have been pretty aggressive about it at the local level.

We really need the Federal Government's help. I would like to thank the Committee for hearing my testimony.

[The prepared statement follows:]

Statement of Gery Chico, President, Chicago School Reform Board of Trustees

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to address you on the issue of how the federal government can play a role in rebuilding America's schools.

I want to begin by thanking Speaker Denny Hastert who recently visited our schools. We shared with him our progress in improving performance and reforming a system once considered one of the worst in the nation. Today, we've been called a national model of reform.

I also want to thank Congressman Charles Rangel—who created the Qualified Zone Academy Bonds.

Chicago was the first school district in the nation to use the bonds. We're using the money to build the city's first JROTC academy—at the site of the former home of the leading African-American military regiment on Chicago's south side.

Thank you Congressman Rangel and the entire committee.

I also want to thank Congressman Rod Blagojevich for making school construction an important issue. Although he's not on the committee, he's been a strong voice for us.

Finally, I want to thank President Clinton and Vice-President Gore for giving attention to this vitally important issue.

Two years ago, the president came to Chicago and met Mayor Daley and me and several others and we outlined the scope of the infrastructure needs in our schools and the local commitment we have made.

Since 1995, Chicago has committed close to $2 billion in primarily local funding for 575 separate projects at 371 schools. That money has built 8 new schools and 48 additions or annexes, adding 632 new classrooms to the district, which serves 430,000 school children.

But more needs to be done, and Chicago cannot do it all alone. We're doing our part, but we need partners at the federal level to meet all the needs.

We've conservatively identified another $1.5 billion in additional improvements needed before we can say that our schools are truly the kinds of learning environments that we know will make a difference.

The fact is, improving the learning environment improves performance. When kids are in crumbling school buildings with outdated equipment, they're getting the message that education isn't important.

When they're in overcrowded classrooms or taking class in hallways or basements because the classrooms are full—they figure school isn't important.

We can't afford to send that message to our children. We're entering a new century. Every forward-thinking industry knows they can pack up and move anywhere on earth and conduct their business.

If we want them to stay here and invest in America, we have to give them a workforce that can deliver—in Chicago and in schools throughout the nation.

The fact is, every school district needs help. Last year, during the Rebuild America's Schools Campaign, we generated 83,000 letters of support from districts all across Illinois, and they all said they needed federal help to rebuild their schools.

In thinking about the plans under consideration, I want to emphasize four basic characteristics of a good school modernization funding plan: simple, flexible, substantial and immediate.

If it's not simple it creates a lot of paperwork, which eats up time and money and doesn't build or modernize schools.

If it's not flexible, it won't help everyone do what they want to do; it will dictate rather than support—and that's *not* appropriate.

If it's not substantial, it's irrelevant. There's an estimated $200 billion in needs nationwide. We need a real commitment—not a token gesture.

And if it's not immediate, it's also irrelevant. The challenge is to do the right thing today—not years from now. Every year our children move another grade. Every year we delay deprives our children of the education they deserve—and need.

Before the committee are two proposals and I want to briefly offer our observations and recommendations. Obviously, we will work with you under any circumstances because the need is so great.

One plan has an arbitrage component that essentially allows school districts to borrow money as they currently do, but invest that money for up to four years—

instead of just two—and then use the extra interest earned toward school improvements.

Our concerns are that this ultimately does not provide enough money to make an impact—nor does it provide any money right away. In Chicago, only one of the four bond issues we have done since 1996 had positive arbitrage and the earnings were negligible—one-tenth of one percent per annum.

It also doesn't work for Chicago because we spend our money as soon as we get it—and most other districts are in the same position. So this arbitrage plan is neither substantial nor immediate.

The other plan, advanced by the President, expands on the QZAB program and creates new school modernization bonds, both of which rely on tax credits. It will offer up to $25 billion in bonding authority to school districts around the country.

From Chicago's standpoint, this is a good plan because it's interest-free subsidy really adds up.

We estimate that the President's school modernization bond program will allow Chicago to issue $676 million in bonds and save us up to $333 million in interest payments. Now that's an incentive and a form of assistance that can really make a difference.

And the federal help would be even more effective if Congress extended the payback period beyond the proposed 15 years to 20, 25, or even 30. Why? Because the principal-only payment for 15 years is the same as, or very close to, the payments of principal and interest over 30 years. As it is currently written, the 15-year payback has almost the same financial burden as if a school district borrowed the money over 30 years with interest.

We also believe that the Department of Education's role should be limited to receiving descriptions of capital plans and annual reports. They should not sign off on individual capital plans.

Unlike the school modernization bonds, the use of QZABs will require substantial business contributions to schools. Unless Congress adjusts the proposal to provide businesses with a substantial incentive to make this investment, many local school districts will be unable to access the program. In fact, under this year's QZAB program, which requires a 10 percent private contribution to the capital cost of projects, we are partnering with five other schools districts in Illinois—Mendota, DeKalb, Aurora, Elgin and East St. Louis—who probably could not have structured a QZAB on their own because of required private contribution. The circumstances probably will be the same under the new business contribution requirement.

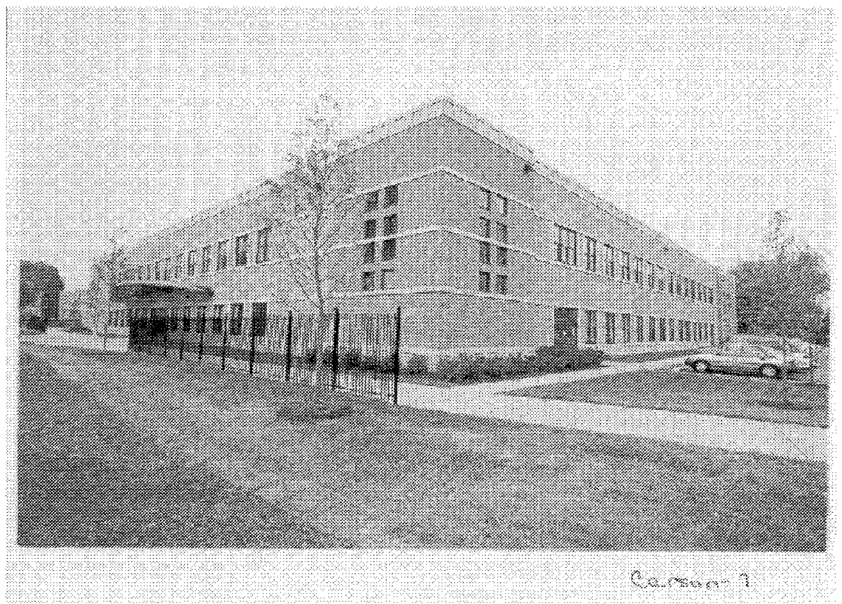
There is also a proposal in the Senate which would enable private investors to use private activity bonds to fund school construction. This proposal seeks to spur private investment in school construction by offering investors significant depreciation incentives along with favorable tax exempt financing. This concept works only if the buildings remain free from real property taxes.

To keep the buildings free from real property taxes, Congress should allow the school district to maintain exclusive title to its property but the tax law should impute a tax basis to the private investor. This would enable the private investor to depreciate the property but avoid a title transfer and real property taxation that would undercut the depreciation tax benefit and the usefulness of the private activity bond.

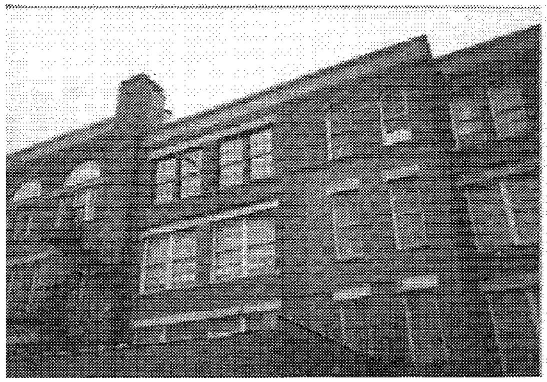
In the space of five minutes, I don't want to revisit the philosophical debate over whether the federal government has any role at all with respect to education. I will just repeat what I said six weeks ago here in Washington when I testified before the House Committee on Education and the Workforce.

America felt it was a national priority to build the interstate highway system in the 1950's, but we've never made the rebuilding of our schools a national priority. But at the dawn of the new millennium, our schools are not merely a national priority—they're a matter of national security and we need to enhance and strengthen them.

Thank you Mr. Chairman and members of the Committee for your time and consideration.

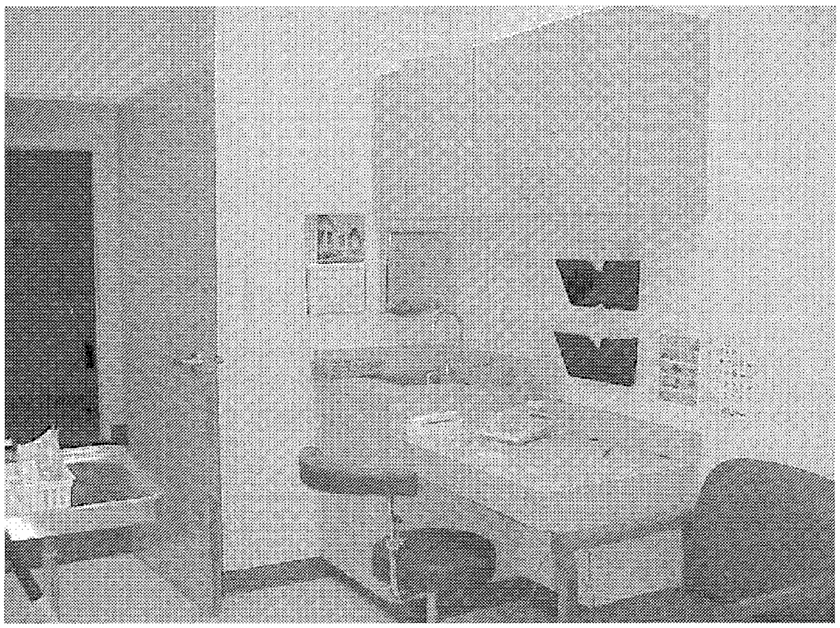


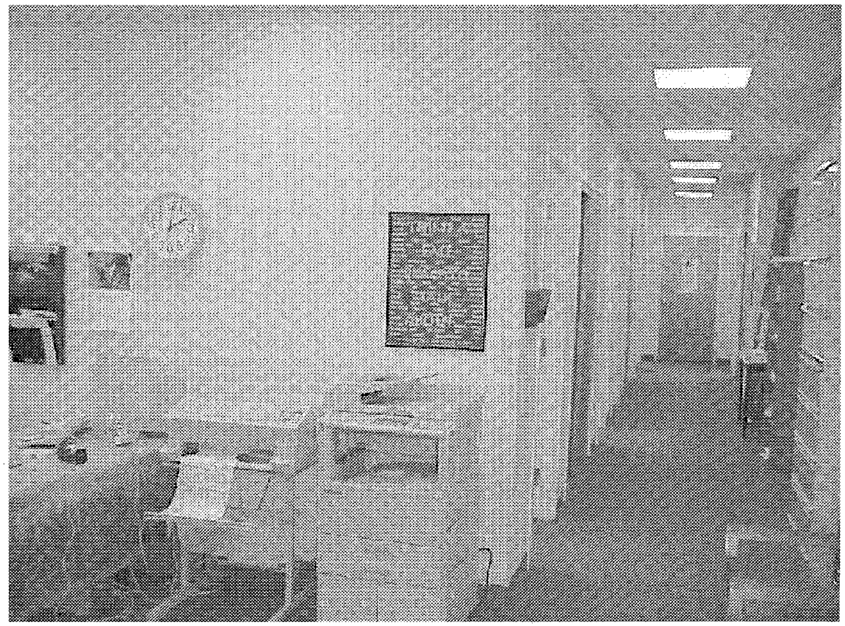
Brentano Acdemy - Region 2, 2723 North Fairfield Avenue
(Exterior Renovation), Before and After



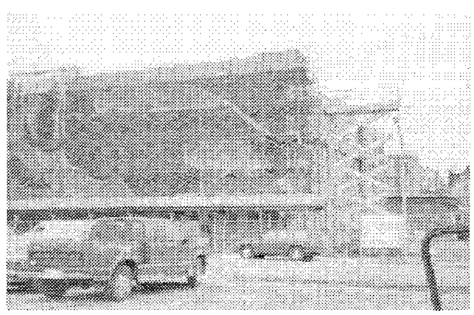

BRENTANO MATH & SCIENCE ACADEMY

Lakeview High School - Region 1, 4015 North Ashland (Health Clinic)

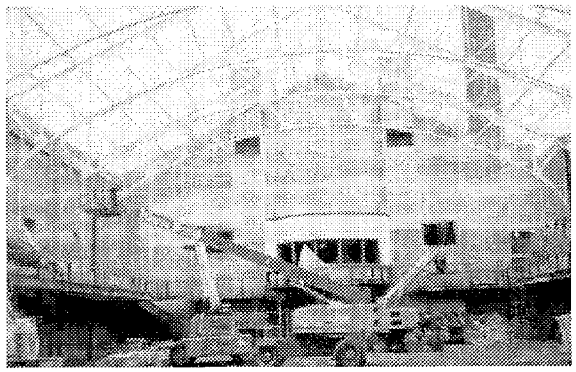




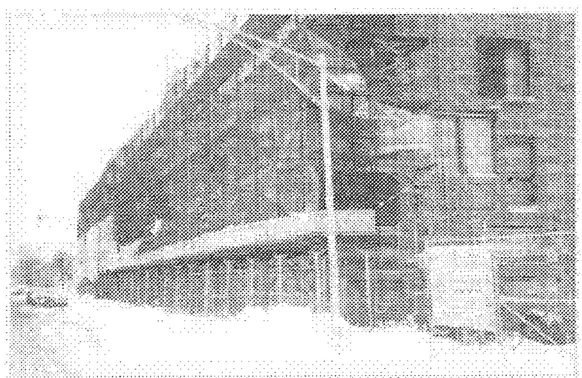
Bronzeville Academy - Region 4, 3519 S. Giles (QZAB - Qualified Zone Academy Bonds)



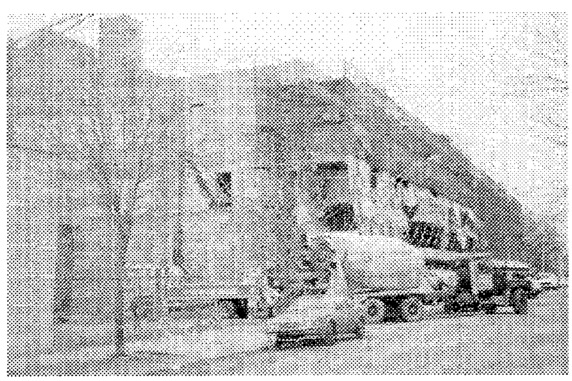
Exterior masonry repair in progress at south and west elevations from the Phase IV parking area.



Drill Hall north interior elevation at Observation Room. Roof steel priming in progress.



South exterior elevation scaffolding for masonry repair.



North and west exterior elevations at Giles alley entrance.

Chairman ARCHER. Thank you, Mr. Chico.

Our next witness will be introduced by one of our own, Mr. Houghton.

Mr. HOUGHTON. Thank you very much, Mr. Chairman. Mr. Bouchard does not come from sunny Florida. He comes from cold, upstate New York. But we are delighted to have him here, distinguished man, distinguished educator for over 39, almost 40 years. He has been superintendent and head of many organizations, one of them being the National Rural Education Association.

Thanks very much for being with us.

Chairman ARCHER. Mr. Bouchard, you have also been identified for the record, so you may proceed.

STATEMENT OF RENE "JAY" BOUCHARD, DISTRICT SUPERINTENDENT, STEUBEN-ALLEGANY COUNTIES, BATH, NEW YORK; CHIEF EXECUTIVE OFFICER, STEUBEN-ALLEGANY BOARD OF COOPERATIVE EDUCATIONAL SERVICES; MEMBER, EXECUTIVE COMMITTEE, AMERICAN ASSOCIATION OF EDUCATIONAL SERVICE AGENCIES; AND MEMBER, EXECUTIVE COMMITTEE, NATIONAL RURAL EDUCATION ASSOCIATION

Mr. BOUCHARD. Thank you, Mr. Chairman. I represent the National Rural Education Association. I would like to speak about the provision in the President's fiscal year 2000 budget that would provide States and local districts desperately needed help in modernizing America's public schools.

Unfortunately, rural schools often are nothing more than an afterthought in the national debate on public education. Nevertheless, I think there is a story to be told. For example, one out of every two public schools in America is located in a rural area or small town. Thirty-eight percent of America's students go to school in rural areas. Forty-one percent of public schoolteachers work in rural schools. Yet rural and small town schools receive only 22 percent of the total funding for K–12 education.

Last year, this Committee succinctly captured the challenge facing the Nation's schools when it stated "A great need exists for construction and renovation of public schools if American educational excellence is to be maintained." Nationwide, the GAO found that it would take $112 billion just to make the necessary repairs on our schools, to ensure that they are safe and healthy for our children. Another $73 billion is needed to build additional schools and enlarging existing schools to alleviate overcrowded conditions. The need for access to the Internet and other technologies is particularly acute in rural areas.

The $22 billion in zero-interest school modernization bonds included in the administration's proposal would put more power in the hands of States and local school districts. The provision would allow bond buyers to receive Federal tax credits in lieu of interest, thereby freeing up money the districts would be paying for interest to be used for teaching and learning.

We are pleased that Representative Charles Rangel of New York, the Ranking Member of this Committee, who will introduce the

President's proposal in the House soon, has expressed a willingness to consider giving a larger allocation to States, potentially resulting in more funds being available to rural schools. Representative Nancy Johnson of Connecticut, a Senior Member on the Majority side of this Committee, will also soon introduce her bill to provide tax credits on school modernization bonds. With such bipartisan support, I strongly urge this Committee to include such school modernization tax credits in any tax bill considered this year.

Another proposal to assist school facilities is being proposed by this Chairman, Chairman Archer, and included in H.R. 2, the leadership's education package. This recommendation would allow for a longer period of time an additional 2 years in which earnings on bond proceeds can be kept by school districts instead of being rebated to the Federal Government. I would recommend though that because of the arbitrage rebate relief proposal, it may benefit larger school districts, as Mr. Chico talked about just recently. But it may be appropriate to include it as an addition to the school modernization bonds in the President's proposal. The Committee should also consider raising the smaller-issuer exemption from $10 million to $25 million, which would provide additional benefits to rural schools that issue bonds below this limit.

One other bill that has just been introduced, H.R. 996, by Representative Etheridge, we heard from earlier here today, also deserves this Committee's attention. This proposal would provide another $7.2 billion in zero-interest bonds targeted to States which have the fastest increases in population in school enrollment.

The American people's attitude toward modernization, stated in a recent survey, that 82 percent said that they support a $22 billion 5-year spending proposal to rebuild America's schools. Americans living in rural areas, 81 percent favor that proposal. Numerous studies have documented the positive correlation between student achievement and better building conditions. A poll of the American Association of School Administrators in April 1997 found that 94 percent of American educators said computer technology had improved teaching and learning. The Internet brings a vast library to our fingertips in a timely and unencumbered manner.

Beyond the educational benefits that technology has to offer modern schools, we ensure that students will be equipped to compete equally and fairly in a job market that is relying more heavily on proficiency in obtaining, synthesizing, and presenting information.

Another example that I wanted to mention was Mr. Chico's remark about the American Society of Civil Engineers, that gave an "F" to education in regard to the study of the infrastructure in this country. Yet while the Congress just last year provided $216 billion for roads, bridges, and mass transit through the highway bill, to date virtually no Federal funds have been made available to improve school buildings.

Mr. Chairman, we appreciate your interest in rural education, and the willingness of your Committee to address the issue of public school construction and renovation. We hope this Committee can actually expand on the President's proposal as it prepares revenue legislation to assist rural communities modernize their schools. Unless we give students equal access to the tools necessary to succeed in the current marketplace, we not only short change them, but we short change ourselves by producing a citizenry unable to maintain our standard of living as a community, and to compete in the global arena. Thank you.

[The prepared statement follows:]

Statement of René "Jay" Bouchard, District Superintendent, Steuben-Allegany Counties, Bath, New York; Chief Executive Officer, Steuben-Allegany Board of Cooperative Educational Services; Member, Executive Committee, American Association of Education Services Agencies; and Member, Executive Committee, National Rural Education Association

Mr. Chairman and Members of the Committee:

On behalf of the National Rural Education Association, I want to thank you for the opportunity to address the Committee. My name is Rene "Jay" Bouchard, and I would like to speak about the provision in the President's Fiscal Year 2000 budget that would provide states and local districts desperately needed help in modernizing America's public schools.

Mr. Chairman, I come before you as someone who in one professional capacity or another has been involved in public education for 39 years. I have had the honor of serving as a teacher, a vice-principal, and principal at the secondary level. I have also served as a superintendent. Since 1982, I have jointly held the positions of Chief Executive Officer for the Steuben-Allegany Board of Cooperative Educational Services, a confederation of 15 rural and small town school districts, and Superintendent of the District of Steuben-Allegany Counties.

I had the privilege of serving as president of the National Rural Education Association, or NREA, from 1993 to 1994. I currently sit on NREA's Executive Committee. I am also a member of the Executive Committee of the American Association of Educational Service Agencies.

I think it would be helpful to speak briefly about NREA. The National Rural Education Association is the oldest established national organization of its kind in the United States. The Association traces its origins back to 1907. Through the years, it has evolved into a strong and respected organization of rural school administrators, teachers, board members, regional service agency personnel, researchers, business and industry representatives, and others interested in maintaining the vitality of rural school systems across the country.

THE NEEDS OF RURAL SCHOOLS

While president of NREA, I had the opportunity to travel extensively throughout the United States and saw first-hand the challenges that schools, administrators, students, and teachers in rural areas and small towns face every day. These schools are more likely than not to be underfunded, and their teachers, when compared to their urban and suburban counterparts, receive lower than average salaries and fewer benefits, have fewer professional development opportunities, and have less access to higher education.

Unfortunately, rural schools often are nothing more than an afterthought in the national debate about public education. Nevertheless, there is a story to be told. For example, one out of every two public schools in America is located in a rural area or small town. Thirty-eight percent of America's students go to schools in rural areas. Forty-one percent of public school teachers work in rural schools. Yet, rural and small town schools receive only 22 percent of the total funding for K–12 education.

Consequently, rural and small town educators must address increasing expectations with diminishing resources. The school modernization proposal in the President's budget proposal can provide desperately needed assistance in the area of greatest need—modernization of school buildings.

Last year, no less a distinguished body than this Committee succinctly captured the challenge facing the nation's schools when it stated: "A great need exists for construction and renovation of public schools if American educational excellence is to be maintained."

I could not have said it better myself.

The common perception among many outside the education community is that the need for modern, safe schools that are not overcrowded, and offer access to the Internet and other education technology exists only in inner-city communities. The truth of the matter, according to a landmark 1996 national study by the General Accounting Office (GAO), "School Facilities: America's Schools Report Differing Conditions," is that one out of two rural schools have at least one inadequate structural and mechanical feature. These include roofs, exterior walls, electrical systems, and heating, ventilation, and air conditioning systems.

In addition, GAO found that 30.3 percent of rural schools, serving more than 4.5 million students, had at least one overall school building that was deemed inadequate.

The age and physical condition of our nation's schools also hinders or prevents many from being retrofitted to accommodate technology. According to the GAO report, the electrical systems at nearly half of all schools are inadequate for full-scale computer use.

Nationwide, GAO found that it would take $112 billion just to make necessary repairs on our schools to ensure that they are safe and healthy places for children to learn. On top of these repair needs, because enrollment in our public schools is at a record high level, and projected to grow every year for at least the next decade, another $73 billion is needed to build additional schools and enlarge existing schools to alleviate overcrowded conditions.

The most recent figures from the National Center for Education Statistics show that while we as a nation have made substantial progress in connecting public classrooms to the Internet, vast disparities remain between disadvantaged and rural school districts and affluent ones. In addition, according to a July 1998 report form the National Telecommunications and Information Administration, rural students (as well as urban and minority students) lack computer access at home and must depend on schools or libraries for access to technology.

The need for access to the Internet and other technologies is particularly acute in rural areas. Because of tight budgets and a limited ability to offer higher level and specialized classes, rural schools are especially reliant on distance learning technologies.

A case in point are the 15 school districts that comprise the Steuben-Allegany Board of Cooperative Educational Services that I oversee. Combined, these western New York districts, which have consolidated many of their administrative and curricular functions to achieve economies of scale, enroll 20,000 students. The districts are spread over 1,600 square miles, an area that is slightly larger than the entire state of Rhode Island.

Over 44 percent of the students in our schools are eligible for the free and reduced price lunch program. That figure climbs as high as 63 percent in some of our schools.

Given how widely dispersed is the area served by the Steuben-Allegany Board of Cooperative Educational Services, the ability to share resources electronically is crucial. In my region, less than 15 percent of our students are in schools with Internet access in their classrooms. Most of our schools only have one or two single station connections to the Internet in the entire school.

THE PRESIDENT'S SCHOOL MODERNIZATION PROPOSAL WOULD HELP RURAL SCHOOLS

The school modernization proposal in the President's budget proposal would go a long way in helping us and others like us to remedy this problem, repair and upgrade all the mechanical systems of our buildings and better respond to environmental hazards in our schools.

The $22 billion in zero interest school modernization bonds included in the Administration's proposal would put more power in the hands of states and local school districts and will not create new federal bureaucracy. Decision making and management prerogatives remain at the local level. By allowing local communities to finance school construction or renovation with the equivalent of interest-free bonds, the proposal presents schools districts with a unique opportunity to renovate existing buildings and build new schoolhouses.

The provision would allow bond buyers to receive federal tax credits in lieu of interest, thereby freeing up money the districts would be paying for interest to be used for teaching and learning. Since over the 15-year repayment period of these school modernization bonds interest payments typically represent as much as 50 percent of the total repayment, the savings to schools from this proposal will be substantial. Fiscal relief to school districts such as mine will help relieve pressure on property taxes, and thus make it easier to convince our local voters to pass school bond referenda.

Combined with the $2.4 billion expansion of the existing Qualified Zone Academy Bond (QZAB) Program, these two proposals would generate nearly $25 billion in bonds at a cost to the U.S. Treasury of $3.1 billion over five years, according to the Joint Committee on Taxation. This is a national investment in schools and in the work force for tomorrow's economy. I also want to add that while the perception of

QZABs is that these bonds only benefit urban areas, any school district with at least 35% of its children eligible for free or reduced-price school lunch also qualifies.

New York State alone would be eligible for more than $2.7 billion in tax credit bonds.

The President's proposal calls for a 50–50 split in bonding authority, with half of the allocation to the states and half to the 100 school districts with the largest number of low-income students. State agencies would assign the bonding authority to districts, schools, or other governmental units based on the family income level of the students to be served, or other factors as they see fit. Most importantly for rural schools is a requirement that the state give special consideration to rural areas, as well as to high-growth areas. Such a funding formula would greatly benefit rural schools.

Additionally, we are pleased that Representative Charles Rangel of New York, the ranking member of this committee, who will introduce the President's proposal in the House soon, has expressed a willingness to consider giving a larger allocation to states, potentially resulting in more funds being available to rural schools. In addition, I am very pleased to note that Representative Nancy Johnson of Connecticut, a senior member on the majority side of this committee, will also soon introduce her own bill to provide tax credits on school modernization bonds. With such bipartisan support I strongly urge this committee to include such school modernization tax credits in any tax bill considered this year.

OTHER SCHOOL MODERNIZATION PROPOSALS

I also want to comment on another proposal to assist school facilities proposed by Chairman Archer, and included in HR 2, the leadership's education package. The Chairman recognized the need for the federal government to assist school communities in his proposal to change arbitrage rules. His recommendation will allow for a longer period of time, an additional two years, in which earnings on bond proceeds can be kept by school districts, instead of being rebated to the federal government. This is a positive proposal that will provide fiscal benefit to some school districts.

However, for many rural districts this proposal will generate little if any additional funds. For most rural districts, if they do pass a bond, they will immediately put those proceeds into the school construction or renovation. The local voters who approve bonds expect projects to be initiated and completed as quickly as possible. I should note that districts with bonds of less than $10 million annually are currently exempt from arbitrage rules, which represents the majority of bonds issues by rural schools.

I would recommend though, that because the arbitrage rebate relief proposal may benefit larger school districts, it may be appropriate to include it as an addition to the school modernization bonds in the President's proposal. The committee should also consider raising the small issuer exemption from $10 million to $25 million, which would provide some additional benefit to rural schools that issue bonds below this limit.

One other bill that has just been introduced, HR 996 by Rep. Etheridge of North Carolina, also deserves this committee's attention. This proposal, intended as an addition to the school modernization bonds in the President's budget, would provide another $7.2 billion in zero interest bonds targeted to states which have had the fastest increases in population and school enrollment. The high growth states that would be the greatest beneficiaries of these bonds include many rural areas.

With the average school building in America greater than 50 years old, we cannot afford to wait any longer for the kind of help the President's proposal would offer. Localities and states, including New York, are addressing this pressing issue as best they can, but they cannot go it alone. The President's proposal provides the framework for the kind of local/state/federal partnership necessary to address this national emergency.

THE PUBLIC SUPPORTS FEDERAL HELP TO MODERNIZE PUBLIC SCHOOLS

The American people understand the connection between safe and modern schools and student achievement. In fact, according to the most comprehensive survey to date on American's attitudes toward school modernization, 82 percent said they support a $22 billion, five-year spending proposal to rebuild America's schools. The survey, conducted on behalf of the Rebuild America Coalition, by leading Republican pollster Frank Luntz in January, found that Americans whether they live in the inner city, the suburbs or rural areas, whether they are affluent or low-income, whether they are black or white, men or women, Republican or Democrat believe that modernizing America's schools is a national priority.

Of those Americans living in rural areas, 81 percent favored such a proposal. Twenty-six percent of rural Americans said that public school buildings in their community were in need of repair, replacement or modernization. Rural Americans said the best reasons to modernize public schools were to ensure a safe and healthy place for children to learn (46.1%) and to provide more space to allow for smaller class sizes (34.2%).

Numerous studies have documented the positive correlation between student achievement and better building conditions. A 1996 study found an 11-point difference in academic achievement between students in classrooms that are substandard and the same demographic group of children in a first-class learning environment. A poll issued by the American Association of School Administrators in April 1997 found that 94 percent of American educators said computer technology had improved teaching and learning.

I have seen first-hand the difference technology can make in the classroom. The range of resource materials available to teachers and students on the Internet is staggering. The Internet brings a vast library to our fingertips in a timely and unencumbered manner. It provides students and teachers alike access to timely, relevant, and interactive information about the world around them and our past.

Children in rural communities as well as children in urban and suburban areas should be educated in modern, well-equipped schools, with small classes. Beyond the educational benefits that technology has to offer, modern schools ensure that students will be equipped to compete equally and fairly in a job market that is relying more heavily on proficiency in obtaining, synthesizing, and presenting information.

One last example of the desperate need for federal help to modernize schools comes from the American Society of Civil Engineers. Last year, this distinguished organization released an analysis of the state of our nation's infrastructure. They analyzed the condition of roads, bridges, wastewater treatment systems, dams, hazardous waste sites, and solid waste disposal sites. They found that public schools buildings are in worse condition than any other part of our nation's infrastructure. Yet, while the Congress just last year provided $216 billion for roads, bridges and mass transit through the highway bill, to date virtually no federal funds have been made available to improve school buildings.

Mr. Chairman we appreciate your interest in rural education and the willingness of your Committee to address the issue of public school construction and renovation. It is crucial that Congress enact the proposals such as the President's school modernization plan. We hope this committee can actually expand on the President's proposal as it prepares revenue legislation to assist rural communities modernize their schools.

Unless we give students equal access to the tools necessary to succeed in the current marketplace, we not only shortchange them but we shortchange ourselves by producing a citizenry unable to maintain our standard of living as a community and to compete in the global arena.

Thank you.

Chairman ARCHER. Does any Member wish to inquire?

Mr. Doggett.

Mr. DOGGETT. Thank you very much.

Mr Chico, we hear so much about what is wrong with public education from those who are determined to undermine it. It is very good to hear some of the right things that are happening in Chicago. I congratulate you on your success.

Mr. CHICO. Thank you.

Mr. DOGGETT. If I understand your testimony, the arbitrage proposal which has been advanced, will do very little for continued improvement in the Chicago public schools?

Mr. CHICO. That is correct.

Mr. DOGGETT. And given its cost, which I think is a little less than $2 billion, if we had that $2 billion to apply in some way to education, you would advise us to apply it somewhere else rather than the arbitrage proposal?

Mr. CHICO. I would say that between the Rangel and Clinton-Gore proposal is about $3.7 billion. I just know for a fact that we could actually access that money and put it to use. Believe me, I don't come here with any bias. If I felt that we could use the arbitrage provision and I ran the calculations and saw if it generated any money for us over the last four issues, I would say let's do it. But it does not.

Mr. DOGGETT. Is it your feeling that that situation is not unique to the Chicago public schools, but that there are many other districts with demands such that they have to apply their bond moneys immediately that there are many other districts around the country that likewise would not benefit significantly from this proposal?

Mr. CHICO. I believe that to be the case. I don't want to speak for New York, but I spoke with the New York representative before the meeting, and you have heard from the small rural district association here, and you have heard from Chicago. That is a pretty good snapshot, I believe.

Furthermore, I would ask the question, I mean who could afford to hold onto their money for 4 years? I mean I have never seen that luxury.

Mr. DOGGETT. So while this proposal might be presented as benefiting all schools, just as every American has the right to buy a Rolls Royce if they can afford it, some of our school districts will not be able to afford to use this provision that would be available to them under this arbitrage bill?

Mr. CHICO. I think so.

Mr. DOGGETT. With reference to our rural schools, Mr. Bouchard, in my State of Texas, some of our rural school districts have got more oil wells than they do children. Then some just a little bit down the highway who, because they have only have rock and cedar trees, can't afford to buy air conditioners for the classrooms. Are there problems that some of our rural school districts around the country face because they are property poor districts?

Mr. BOUCHARD. Absolutely. I come from an area in the Finger Lakes region of New York that is the same as what you are talking about, very, very, very poor. I have been in the inner city of New York City, and I have seen more poverty in my area than I have seen in New York City schools.

Mr. DOGGETT. Do you think that it is appropriate that as we look at this whole school construction issue, that we focus on at least if not addressing these inequities between property-poor and property-rich districts, at least try not to exacerbate them and make them worse by simply passing legislation that only the richest can take advantage of?

Mr. BOUCHARD. Absolutely.

Mr. DOGGETT. Thank you very much. Thank you both, and the entire panel.

Mrs. THURMAN. Mr. Chairman.

Chairman ARCHER. Mrs. Thurman.

Mrs. THURMAN. Dee, let me ask you just a couple of questions. In reading your testimony and looking at some of the language from the tax stuff that was given to us by the administration, there is one area that has me a little confused. There is something in there about retroactive tax increases. But at the same time, it says that this proposal or this initiative would actually take place the day this bill is passed. Can you explain the retroactive issue for us?

Ms. THOMAS. Yes. I think so. Again, it is not a simple thing to understand. But I think effectively what happens is that in this proposal is that there really isn't any effective date. It talks about an effective date. What really happens is there is not really an effective date.

The proposal goes on to say that we would be able to take deduction for distributions and apply that against the UBIT. Then it goes on to say that companies such as ours that have already enacted the sub S ESOP, that we would have to—we wouldn't be able to use that benefit. We would have to just keep applying that until we had paid off what we have already used. So for us, and for any like us, there is really no effective date because it is going to be the same for all sub S ESOPs. So that is the retroactive problem that we have.

Mrs. THURMAN. And then the other issue, and I guess maybe to the two colleagues that came with you as well, based on your understanding, do you think you could remain as an ESOP and as an independent company at this point?

Ms. THOMAS. I think that it would be difficult for us. Number one, this Committee needs to understand that Ewing & Thomas functions in a world of a lot of federally regulated Medicare money. There are a lot of changes that are occurring that are really hitting on the independent practitioners, and especially the small independent physical therapists. Not just this issue, but some supervision issues and so the list goes on. So that is not helping us. We are kind of in the squeeze between that and now the sub S.

The sub S ESOP issue, with the proposal, there is so much, I call it gobbley-goop, because it's very difficult for a regular ordinary businessperson to understand. So that is going to cost us administrative costs from a lawyer and evaluation and administration firms. That is probably going to be over what we already paying. Then we are looking at the possibility of like a 40-percent tax, so we'll have that. Plus again, the administrative fee. Then we have our repurchase liability that we also have to continue to worry about.

So the proposal is going to be difficult for those of us that made the election in good faith.

Mrs. THURMAN. Thank you.

Mr. Marvin, I just want to say that I appreciate your being here. I think the issues that you have raised as we go into the next millennium are extremely important to this country. I am a cosponsor—also I am one of the people on the efficiency on energy. We really appreciate you all bringing these issues to us, because they are very important into the future. Also, I would say to our school districts, I have some large schools districts and I have some rural districts, but I am also a former teacher. So I understand. And a seventh and eighth grade, not university.

Mr. CHICO. You were on the frontlines.

Mrs. THURMAN. I was right on the frontlines, and I actually worked in a portable. So I can appreciate what you are saying and certainly can appreciate from a standpoint of children learning, and how important it is that they are in an environment, if nothing else, to have the technical advancements that are available in any kind of modernization that we do. So we certainly appreciate the time you have taken. Mr. Hill, we thank you for being here too.

Chairman ARCHER.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Chico, does Chicago School Reform board of trustees, is that the Chicago——

Mr. CHICO. School board.

Mr. COLLINS. School board?

Mr. CHICO. What they did, Congressman, is we were in such bad shape 4 years ago they virtually created an emergency act. The Illinois legislature turned over the power for the control of the schools to the Chicago mayor. They created this interim board called the Reform Board of trustees, using the word trustees to connote urgency.

Mr. COLLINS. OK. Well then you are actually the school board?

Mr. CHICO. We are the school board. We are the school board.

Mr. COLLINS. So you are familiar with all the areas of the cost of education?

Mr. CHICO. Yes.

Mr. COLLINS. Versus just the cost of construction of schools.

Mr. CHICO. Yes, sir.

Mr. COLLINS. In relation to that, are you familiar or do you have other areas of funding that are supposed to come from the Federal level but don't come, and the lack of that causes you to have to——

Mr. CHICO. Yes.

Mr. COLLINS [continuing]. Cough up moneys in other areas that prohibit you from using it for construction, such as the IDEA?

Mr. CHICO. Yes, sir. Special education. We receive about 8 percent from the Federal Government, and the Federal Government has set a target for itself of providing 40 percent to the cost of our special education.

Mr. COLLINS. Should the Congress come up with more funding in that area, would it free up some funds for you to be able to use for your school construction?

Mr. CHICO. Yes, sir.

Mr. COLLINS. So if the bond issue, the bond provisions were not put in place, there are other places you possibly could get funds from then?

Mr. CHICO. Absolutely. The money is money. What we would do is if the Congress saw fit to increase the amounts sent to school districts for special education, we would take that money, take out the general dollars that we now put in from the local level into special education, put that back into other purposes like school construction.

Mr. COLLINS. Are there other areas that are mandates that the Federal Government or the Congress puts on you that costs you money that you could use for this same purpose if those type of regulations were giving some relief to you?

Mr. CHICO. There is probably a smattering of what you would call unfunded mandates, Congressman. But none are as poignant as the special education shortfall.

Mr. COLLINS. Oh I am sure there's not. That is a very expensive item.

Mr. CHICO. Yes.

Mr. COLLINS. But I am just thinking that the Congress, in its attempt to oftentimes fund different areas, will put mandates down and cause certain things that you have to do in reporting and administrative costs too that cost a billion to the operation versus the moneys you actually receive.

Mr. CHICO. There is no doubt about it, Congressman. I will give you a short story. When the Illinois legislature in 1995 created this emergency act to give the mayor responsibility for the Chicago public schools, they also gave us flexibility to use funds in different ways. So instead of mandating that there is a particular formula for how to fund something, they put the money in a general bloc, sent it to the Chicago public schools. I think we have used it very effectively, because over a 15-year period, they never had a balanced budget. For the last 4 years, we have had balanced budgets, and we hope to have them until 2003 at least, when our labor agreement expires.

Mr. COLLINS. You said the State did this?

Mr. CHICO. The State of Illinois. The Chicago Board of Education is a separate municipal corporation established by State statute. So the State is our ultimate authority.

Mr. COLLINS. Yes. So the State kind of block-granted down to you the funds, and says you use it for education.

Mr. CHICO. Yes.

Mr. COLLINS. Are you familiar with the fact that in the last Congress, we passed something very similar, called Dollars for the Classroom Act, that would have given you funds with the flexibility to use them as you see need for the classroom?

Mr. CHICO. I am not familiar with how much flexibility we received as an individual school district. I understand that the legislation was designed pretty much to give flexibility at the State level. In turn, that was supposed to benefit us. We are all for that in concept. Anything that allows us—we feel we can pretty much solve a lot of our own problems, not all of them, I mean here I think we have made a very good-faith effort at raising $2 billion from local taxpayers, but unfortunately, the nature of the need is still greater. That is why we are looking to the Congress for help.

Mr. COLLINS. Yes. I fully understand because in the third district of Georgia that I represent, we have some mayors that are very fast growing. They are having growing pains, similar to what you are having.

Thank you very much. I think you will see this Congress try to give you some relief in several areas, such as mandates, and also the area of the IDEA.

Mr. CHICO. Thank you very much, Congressman.

Mr. COLLINS. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. I am glad I got back here in time.

I would like to direct my question to local school superintendent from Illinois, Gery Chico. I see you met Mr. Collins, who was directing some questions here. I particularly want to thank you for acknowledging the bipartisan partnership that worked, when we had a Republican Majority in the House and a Republican Majority in the State senate, and of course a Republican Governor, and they worked with Mayor Daley and got rid of some dead wood and made some changes. The mayor is taking advantage of that. Your team has done a good job of bringing about some positive change.

Mr. CHICO. Thank you, Congressman.

Mr. WELLER. Its beneficiaries are the kids. So I salute you and want to thank you for that. I also appreciate the opportunities I have had as a Representative of Chicago to visit your schools and see first-hand the good work that you are doing.

Mr. CHICO. You are always welcome.

Mr. WELLER. When you and I have had conversations, you are particularly, of course, interested in the school construction bond initiatives that come before us. As Rod Blagojevich, my former colleague in the assembly remembers, I was the sponsor of a similar initiative when I was in the State legislature. So I have always been a strong supporter, and I think recognize the need to fix leaking roofs and need for new classrooms.

Just for the record though, in the State of Illinois, I know in the State legislature and the Governor in the last couple years have approved a school construction funding initiative. How much is that, and how long is that in place for?

Mr. CHICO. It's $1.3 billion. It goes for about 5 years. The unfortunate part of the problem is that the estimated need for the State of Illinois is about $12 to $13 billion. One of the other shortcomings we believe, Congressman, of the Illinois mechanism is that 5 years trickles the money out to Chicago too long. We would like to have the ability to borrow against that longer stream and do the job today so that we don't have to wait 4 years to get to the leaky roof and make it an entirely new roof rather than a patch job.

Mr. WELLER. OK. Again, I'm sorry, the dollar amount?

Mr. CHICO. It's 1.3.

Mr. WELLER. It's 1.3 over 5. Then the Chicago public schools, your own school district, also has a school construction initiative. What is the total on that?

Mr. CHICO. Two billion.

Mr. WELLER. So your share of the State?

Mr. CHICO. Two fifty.

Mr. WELLER. Two hundred and fifty million. So you have essentially got almost $1.5 billion that will be essentially yours coming from both the State initiative and then from the local initiative?

Mr. CHICO. It works out like this: $2 billion was raised locally, and about $250 million from that $1.3 billion State issue will come to Chicago also. So about $2.25.

Mr. WELLER. That's $2.25 billion.

Mr. CHICO. Total for Chicago.

Mr. WELLER. Total. Then the QAZ, Qualified Academy Zone, bonds that qualify, the zone academy bonds that were part of the Balanced Budget Act and came as an initiative out of this Committee, how are you using them within the Chicago public schools?

Mr. CHICO. I think we were the first in the country to access the qualified academy zone bonds. Last year, the State allocation was about $14.5 million. We were the only district that stepped up and asked for the allocation, so we were given the entire allocation. We took it and we renovated an old United States armory and we created an ROTC high school for the city at 38th and Calumet, along with an African-American military museum right next to it.

This year, we are going for—we are working with five other districts, plus Chicago, for the $15 million State allocation. As I said in my testimony, Chicago will work with East St. Louis, DeKalb, Aurora, Elgin, and Mendota, to share that $15 million pool. But what will happen here, Congressman, is Chicago will do the brunt of the work and help raise the 10-percent, private-sector match because that $1.5 million is a lot of money to ask a rural town or a smaller town to go get.

Mr. WELLER. Reclaiming my time. Is it a coincidence four of those five school districts are in the district of the Speaker of the House? [Laughter.]

Mr. CHICO. No, not really, because I'll tell you what. If we had our druthers—no, not necessarily. If we had our druthers, we have actually reached out to other people, too, around the State. These are the ones that have come forward first. We would like to work with 40 or 50 districts.

Mr. WELLER. Sure. I'm of course running out of time here. Let me ask this, just on a philosophical standpoint. As we have talked, and Mr. Collins brought this issue up, is we have worked to give you greater flexibility and shift dollars back to the States, and of course trying to get more dollars into the classroom. Who would you rather apply to for the funds, the Illinois State Board of Education or the Federal Department of Education?

Mr. CHICO. It depends who will give them to me quicker.

Mr. WELLER. Well today, under today's circumstance, who has less paperwork and who is the most responsive?

Mr. CHICO. Congressman, in my testimony I said that I do not believe the United States Department of Education should sign off on our money. I said that we will be glad to observe a reporting requirement. I think there ought to be some checks and balances. But I do not believe we should make undue stops for undue labor of review of a plan. I mean I think this is fairly basic stuff. You are either fixing the building or you're not fixing the building. You are building a new classroom or you're not.

The State of Illinois has been very good. They have used the Capital Development Board in Illinois. They have been a very quick vehicle to transfer that money to the local districts. So if our suggestion is heeded, then I think we will be OK at the Federal level, too. But I don't think we should create another organization for a very involved process to get sign-off from at the Federal level.

Mr. WELLER. Thank you. Thank you, Mr. Chairman. I see I am out of time.

Chairman ARCHER. I was going to say, "gentlemen," but we have a wonderful lady on this panel too. My gratitude to all of you for coming and giving us the benefit of your testimony today. We have all learned a lot. We thank you, and we wish you well.

There being no further business before the Committee, the Committee will stand adjourned.

[Whereupon, at 5:12 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of America's Community Bankers

Mr. Chairman and Members of the Committee:

America's Community Bankers appreciates this opportunity to submit testimony for the record of the hearing on the revenue raising provisions in the Administration's fiscal year 2000 budget proposal. America's Community Bankers (ACB) is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees and 15,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance, and community development.

ACB wishes to focus on five provisions included in the Administration's budget. We urge the Committee to reject the Administration's proposals to change the rules for bank-owned life insurance, modify section 1374, tax the investment earnings of section 501(c)(6) organizations, and eliminate "corporate tax shelters." On the other hand, we recommend that the Committee include in legislation, as soon as possible, the Administration's proposal to increase the low-income housing tax credit.

BANK-OWNED LIFE INSURANCE

ACB strongly disagrees with the Administration's proposal to disallow deductions for interest paid by corporations that purchase permanent life insurance on the lives of their officers, directors, and employees. This disallowance is retroactive in that it would occur with respect to life insurance contracts already in force. The Administration's proposal would revamp a statutory scheme enacted just two years ago. In 1997 Congress enacted a provision to disallow a proportional part of a business's interest-paid deductions on unrelated borrowings where the business purchases a life insurance policy on anyone and where the business is the direct or indirect beneficiary. Integral to this general rule, however, is an exception for business-owned life insurance covering employees, officers, directors, and 20 percent or more owners. The combination of the general rule and its exception implemented a sensible policy—that the benefits of permanent life insurance, where they are directly related to the needs of a business, should continue to be available to businesses

The Administration is now proposing that the implicit agreement made two years ago be broken by eliminating the exception for employees, officers, and directors for taxable years beginning after the date of enactment. It would continue to apply to 20-percent owners. Thus, a portion of the interest-paid deductions of a business for a year would be disallowed according to the ratio of the average unborrowed policy cash values of life insurance, annuities, and endowment contracts to total assets. Insurance contracts would be included in this denominator to the extent of unborrowed cash values. (It also appears that a 1996 exception that permits an interest-paid deduction for borrowings against policies covering key employees would be repealed.)

The Administration's proposal would result in a significantly larger loss of deductions for a bank or thrift than a similar-sized commercial firm because financial institutions are much more leveraged than commercial firms. Financial institutions, because of their statutory capital requirements, have been under a special constraint to look to life insurance to fund retirement benefits after the issuance of FASB Statement 106 in December 1990. FASB 106, which was effective for 1992, requires most employers to give effect in their financial statements to an estimate of the future cost of providing retirees with health benefits. The impact of charging such an expense to the earnings of a company could be a significant reduction in capital. Many financial institutions were faced with the necessity of reneging on the commitments they had made to their employees or finding an alternative investment. Many of these institutions have chosen to fund their pension obligations, as well as retiree health care benefits, using permanent life insurance.

The banking regulators have permitted financial institutions to use life insurance to fund their employee benefit liabilities, but restricted the insurance policies that may be used to those that do not have a significant investment component and limited the insurance coverage to the risk of loss or the future liability. (See e.g., the OCC's Banking Circular 249 (February 4, 1991) and the OTS's Thrift Activities Regulatory Handbook, Section 250.2.) On September 20, 1996, the OCC issued Bulletin 96–51 which recognized the usefulness of permanent life insurance in the conduct of banking and granted banks increased flexibility to use it—consistent with safety and soundness considerations. The bulletin makes clear that the necessity to control a variety of risks created by life insurance ownership (liquidity, credit, interest rate, etc.) requires a bank to limit its purchases to specific business needs rather than for general investment purposes. In addition, bank purchases of life insurance will be limited by the need to maintain regulatory capital levels. (The other bank regulators are in agreement with the OCC position.)

The Administration's proposed change in the current law treatment of business-owned life insurance would require many financial institutions, because of the extent of their loss of deductions, to terminate their policies. Policy surrender would, however, subject the banks to immediate tax on the cash value and possible cash-in penalties that would reduce capital.

In most cases financial institutions have purchased life insurance to provide pension and retiree health benefits. If Congress were to make it uneconomical for businesses to purchase life insurance contracts, the employee benefits they fund would inevitably have to be reduced. For the Administration to make business-owned life insurance uneconomical, given its usefulness in providing employee benefits, is inconsistent with the other proposals in the Administration's budget proposal that would enhance pension and other retiree benefits.

The Administration's argument that financial intermediaries are able to arbitrage their interest-paid deductions on unrelated borrowings where they own permanent life insurance is unconvincing. The leveraging of their capital by banks and thrifts to make loans is a vital component of a strong economy. The Administration's proposal would punish financial institutions, simply because they are inherently much more leveraged, to a much greater extent than similar-sized commercial firms for making what would otherwise be sound business decisions—to insure themselves against the death of key employees or to provide for the retirement health or security of their employees by means of life insurance.

This is the fourth year in a row that legislation has been proposed to limit the business use of life insurance. This is the second year in a row that the Administration has asked Congress to find a relationship between life insurance on employees, officers, and directors that a corporation owns or is the beneficiary of and general debt issued on the credit of the corporation. The continuing attacks on corporate-owned life insurance deprive taxpayers of certainty and, from the Administration's point of view, are counterproductive. Corporate taxpayers may feel compelled to purchase life insurance to qualify for the current tax treatment before the opportunity is lost. ACB urges the Committee to unequivocally affirm that the current law treatment of corporate-owned life insurance represents a sound compromise that should not be disturbed.

LOW-INCOME HOUSING TAX CREDIT

America's Community Bankers strongly supports the Administration's proposal to increase the per capita limit on the low-income housing tax credit from $1.25 to $1.75. As an important part of the thrift industry's commitment to housing, ACB's member institutions have been participants, as direct lenders and, through operating subsidiaries, as investors, in many low-income housing projects that were viable only because of the LIHTC. The ceiling on the annual allocation of the LIHTC has not been increased since the credit was created by the Tax Reform Act of 1986. Many member institutions have communicated to ACB that there are shortages of affordable rental housing in their communities and that, if the supply of LIHTCs were increased, such housing could be more efficiently be produced to address this shortage.

The LIHTC was created in 1986 to replace a variety of housing subsidies whose efficiency had been called into question. Under Section 42 of the Internal Revenue Code, a comprehensive regime of allocation and oversight was created, requiring the involvement of both the IRS and state and local housing authorities, to assure that the LIHTC is targeted to increase the available rental units for low-income citizens. This statutory scheme has been revised in several subsequent tax acts to eliminate potential abuses.

Every year since 1987, each state has been allocated a total amount of LIHTCs equal to $1.25 per resident. The annual per capita limit may be increased by a reallocation of the unused credits previously allocated to other states, as well as the state's unused LIHTC allocations from prior years. The annual allocation must be awarded within two years or returned for reallocation to other states. State and local housing authorities are authorized by state law or decree to award the state's allocation of LIHTCs to developers who apply by submitting proposals to develop qualified low-income housing projects.

A "qualified low-income project" under Section 42(g) of the Code is one that satisfies the following conditions. (1) It must reserve at least 20 percent of its available units for households earning up to 50 percent of the area's median gross income, adjusted for family size, or at least 40 percent of the units must be reserved for households earning up to 60 percent of the area's median gross income, adjusted for family size. (2) The rents (including utility charges) must be restricted for tenants in the low-income units to 30 percent of an imputed income limitation based on the number of bedrooms in the unit. (3) During a compliance period, the project must meet habitability standards and operate under the above rent and income restrictions. The compliance period is 15 years for all projects placed in service before 1990. With substantial exceptions, an additional 15-year compliance period is imposed on projects placed in service subsequently.

Putting together a qualifying proposal is only the first step, however, for a developer seeking an LIHTC award. The state or local housing agency is required to select from among all of the qualifying projects by means of a LIHTC allocation plan satisfying the requirements of Section 42(m). The allocation plan must set forth housing priorities appropriate to local conditions and preference must be given to projects that will serve the lowest-income tenants and will serve qualified tenants for the longest time.

Section 42 effectively requires state and local housing agencies to create a bidding process among developers to ensure that the LIHTCs are allocated to meet housing needs efficiently. To this end the Code imposes a general limitation on the maximum LIHTC award that can be made to any one project. Under Section 42(b) the maximum award to any one project is limited to nine percent of the "qualified basis" (in general, development costs, excluding the cost of land, syndication, marketing, obtaining permanent financing, and rent reserves) of a newly constructed building. Qualified basis may be adjusted by up to 30 percent for projects in a qualified census tract or "difficult development area." For federally subsidized projects and substantial rehabilitations of existing buildings, the maximum annual credit is reduced to four percent. The nine and four percent annual credits are payable over 10 years and in 1987, the first year of the LIHTC, the 10-year stream of these credits was equivalent to a present value of 70 percent and 30 percent, respectively. of qualified basis. Since 1987, the Treasury has applied a statutory discount rate to the nominal annual credit percentages to maintain the 70 and 30 percent rates.

The LIHTC has to be taken over 10 years, but the period that the project must be in compliance with the habitability and rent and income restrictions is 15 years. This creates an additional complication. The portion of the LIHTC that should be theoretically be taken in years 11 through 15 is actually taken pro rata during the first 10 years. Where there is noncompliance with the project's low-income units during years 11 through 15, the related portion of the LIHTC that was, in effect, paid in advance will be recaptured.

Where federally subsidized loans are used to finance the new construction or substantial rehabilitation, the developer may elect to qualify for the 70 percent present value of the credit by reducing the qualified basis of the property. Where federal subsidies are subsequently obtained during the 15-year compliance period, the qualified basis must then be adjusted. On the other hand, certain federal subsidies do not affect the LIHTC amount, such as the Affordable Housing Program of the Federal Home Loan Banks, Community Development Block Grants, and HOME Investment Partnership Act funds.

The LIHTCs awarded to developers are, typically, offered to syndicators of limited partnerships. Because of the required rent restrictions on the project, the syndications attract investors who are more interested in the LIHTCs and other deductions the project will generate than the unlikely prospect of rental profit. The partners, who may be individuals or corporations, provide the equity for the project, while the developer's financial stake may be limited to providing the debt financing.

The LIHTC is limited, however, in its tax shelter potential for the individual investor. Individuals are limited by the passive loss rules to offsetting no more than $25,000 of active income (wages and business profits) with credits and losses from rental real estate activities. For an individual in the 28% bracket, for example, the benefit from the LIHTC would be limited to $7,000. It should also be borne in mind that such credits are unavailable against the alternative minimum tax liability of individuals and corporations.

Three years ago the Chairs of the Ways and Means Committee and its Subcommittee on Oversight requested the GAO to study the LIHTC program and, specifically, to evaluate: whether the LIHTC was being used to meet state priority housing needs; whether the costs were reasonable; and whether adequate oversight was being performed. The resulting GAO report was generally favorable. See *Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program* (GAO/GGD/RCED–97–55, March 28, 1997). The GAO found that the LIHTC has stimulated low-income housing development and that the allocation processes implemented by the states generally satisfy the requirements of the Code. In fact, the GAO found that the LIHTC was being targeted by the states to their very poorest citizens. The incomes of those for whom the credit was being used to provide housing were substantially lower than the maximum income limits set in the statute. While the GAO could find no actual abuses or fraud in the LIHTC program, it did determine that the procedures that some states use to review and implement project proposals need to be improved. The report also recommended a number of changes in the IRS regulations to ensure adequate monitoring and reporting so that the IRS can conduct its own verification of compliance with the law.

The only increase in the total amount of LIHTCs since 1987 has been through population growth, which has been only five percent nationwide over the 10-year period (floor statement of Senator Alphonse D'Amato, October 3, 1997). Had the $1.25 per capita limit been indexed for inflation since the inception of the LIHTC, as is commonly done in other Code provisions, it would be comparable to the $1.75 limit the Administration is proposing. According to the Joint Committee on Taxation, the Consumer Price Index measurement of cumulative inflation between 1986 and the third quarter of 1998 was approximately 49.5 percent. Using this index to adjust the per capita limit, it would now be approximately $1.87. The GDP price deflator for residential fixed investment indicates 39.9 percent price inflation, which would have increased the per capita limit to approximately $1.75. (See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* (JCS–1–99), February 22, 1999)

More affordable low-income housing is currently needed. "Despite the success of the Housing Credit in meeting affordable rental housing needs, the apartments it helps finance can barely keep pace with the nearly 100,000 low cost apartments which were demolished, abandoned, or converted to market use each year. Demand for Housing Credits currently outstrips supply by more than three to one nationwide. Increasing the cap as I propose would allow states to finance approximately 27,000 more critically needed low-income apartments each year using the Housing Credit, helping to meet this growing need." (floor statement of Representative Nancy Johnson, January 6, 1999). "In the state of Florida, for example, the LIHTC has used more than $187 million in tax credits to produce approximately 42,000 affordable rental units valued at over $2.2 billion. Tax credit dollars are leveraged at an average of $18 to $1. Nevertheless, in 1996, nationwide demand for the housing credit greatly outpaced supply by a ratio of nearly 3 to 1. In Florida, credits are distributed based upon a competitive application process and many worthwhile projects are denied due to a lack of tax credit authority" (floor statement of Senator Bob Graham, October 3, 1997).

"In 1996, states received applications requesting more than $1.2 billion in housing credits—far surpassing the $365 million in credit authority available to allocate that year. In New York, the New York Division of Housing and Community Renewal received applications requesting more than $104 million in housing credits in 1996—nearly four times the $29 million in credit authority it already had available" (floor statement of Senator Alphonse D'Amato, October 3, 1997). "The Housing Credit is the primary federal-state tool for producing affordable rental housing all across the country. Since it was established, state agencies have allocated over $3 billion in Housing Credits to help finance nearly one million homes for low income families, including 70,000 apartments in 1997. In my own state of Connecticut, the Credit is responsible for helping finance over 7,000 apartments for low income families, including 650 apartments in 1997 (floor statement of Representative Nancy Johnson, January 6, 1999).

Based on the foregoing, it is clear that it is time to increase the LIHTC.

Repeal of Section 1374 for "Large" Corporations

Under the Administration's budget proposal, section 1374 would no longer apply to corporations that have a value of more than $5 million. The repeal of section 1374 would apply to Subchapter S elections that become effective after December 31, 1999. Section 1374 was enacted by the Tax Reform Act of 1986 in order that taxpayers could not avoid the repeal of the *General Utilities* rule (see *General Utilities v. Helvering*, 296 US 200 (1935)) that was one of the primary achievements of the 1986 Act. Under the *General Utilities* rule, a corporation could avoid corporate level tax on appreciated property by distributing such property to its shareholders. Section 1374 was enacted in lieu of the kind of liquidation tax now being proposed by the Administration. Section 1374 provides that the "built-in" gain on appreciated assets held by a corporation that makes a Subchapter S election will be triggered where the assets are disposed of within 10 years of the election. Ten years, though an essentially arbitrary period, is long enough to indicate conclusively that the taxpayer did not have a tax avoidance motive on these amounts for making the election.

The current Administration proposal first appeared in the *President's Seven-Year Balanced Budget Proposal*, published in December 7, 1995. It provides that a "large" regular corporation—with a value of more than $5 million—electing to become a Subchapter S corporation or merging into one will be treated as if it were liquidated, followed by the contribution of the assets its shareholders received in exchange for their stock to the S corporation. The proposal would impose taxation on any appreciated assets held by the corporation and would tax the shareholders as if they had sold their stock and reinvested the proceeds in the new Subchapter S entity.

Although as a general matter, enactment of the Administration's proposal would probably make the Subchapter S election too expensive for many existing corporations, including commercial banks, the proposal would impose a particular and prohibitive tax liability on the typical savings institution or savings bank (thrift). In effect, Congress will have made only a hollow gesture towards making Subchapter S status available to thrifts.

Last year Congress advanced the ongoing process of financial modernization by making it possible for thrifts to change to commercial bank charters or to diversify their lending activities to diminish risk created by concentrated lending and to better serve their communities. This was accomplished by requiring all thrifts to "recapture" into taxable income their loan loss reserves accumulated after 1987, except to the extent necessary to create an opening reserve balance for those "small" thrifts permitted to remain on the experience reserve method. The threat of subjecting the remaining, pre–1988 reserve accumulation to recapture upon a charter change or a diversification of the institution's loan portfolio was dispelled. Recapture of the pre–1988 reserve will still occur, however, where the thrift liquidates or otherwise distributes the capital accumulated using the special thrift subsidy reserve method that had been in existence since 1952 but that was repealed by Congress last year. Almost any established thrift that is forced to recapture the capital accumulated between 1952 and 1987 from the special thrift reserve method would suffer a huge cut in its capital and a likely regulatory capital shortfall, given the importance of the previous deductions permitted under the method.

Although in Notice 97–18, published in the Internal Revenue Bulletin 1997–10 on March 10, 1997, the Internal Revenue Service distinguished the pre–1988 reserves of a thrift from the experience reserves subject to recapture as a section 481(a) adjustment, there can be little doubt that the pre–1988 reserves satisfy the definition of a built-in gain in section 1374(d)(5) of the Internal Revenue Code.

ACB concurs with other commentators that the Administration's proposal to repeal 1374 is not sound tax policy. The taxation of excess passive income, as well as the 10-year holding period requirement to avoid the taxation of built-in gains, limits the ability of corporations to avoid tax by making a Subchapter S election. The proposed repeal of section 1374 for large corporations would eliminate the realization concept to such an extent that a corporation may be unable to pay the required tax without an actual liquidation of the assets of the business. This proposal would contravene one of the principal purposes of the amendments to the Subchapter S provisions made in 1982 and 1996—to increase the attractiveness and availability of the Subchapter S election.

At a minimum, however, ACB strongly requests that, if the Committee were to agree with the Administration on the need to impose liquidation treatment on certain Subchapter S conversions, an exception be created to avoid the recapture of the pre–1988 loan loss reserves of thrifts. The very purpose of the amendments to the reserve recapture rules made last year was to limit the circumstances in which reserve recapture will be imposed. It is inconsistent to create a new situation in which recapture will be imposed. The Administration's proposal will force many eligible thrifts to make the Subchapter S election on a rush basis, rather than be effectively foreclosed after the 1999 calendar year. The provision creates a trap for the unwary thrift that could have a devastating impact on its capital. This proposal will raise little, if any, revenue from the thrift industry if their pre–1988 reserves are made subject to recapture under it.

Investment Earnings of 501(c)(6) Organizations

Section 501(c)(6) of the Code creates an income tax exemption tax for nonprofit business leagues, chambers of commerce, and professional and trade associations. Such organizations are not taxed on the revenues derived from membership dues and exempt purpose activities. Income derived from business activities unrelated to the tax-exempt purpose is, however, taxed under section 511 of the Code at the regular corporate rate, but an exclusion is provided for interest, dividends, royalties, certain rental income, certain gains from the disposition of property, and certain other income.

The Administration is proposing to tax the "net investment income" of section 501(c)(6) organizations—i.e., the interest, dividends, rents, royalties, and certain gains and losses from the disposition of property, minus all directly connected expenses. An exception would be provided for the first $10,000 earned by an association from these sources, but all investment income over the $10,000 floor will be subject to the unrelated business income tax (UBIT).

The Treasury provides the following rationale for the proposal:

> The current-law exclusion from the UBIT for certain investment income of a trade association allows the organization's members to obtain an immediate deduction for dues or similar payments to the organization in excess of the amounts needed for current operations, while avoiding tax on a proportionate share of the earnings from investing such surplus amounts. If the trade association member instead had retained its proportionate share of the surplus and itself had invested that amount, the earnings thereon would have been taxed in the year received by the member. Although in some instances investment income earned tax-free by a trade association may be used to reduce member payments in later years, and hence reduce deductions claimed by members in such years, the member still has gained a benefit under current law through tax deferral. Thus, under current-law rules, trade association members may be able to claim current deduction for future expenses. Even assuming that dues and similar payments would be deductible by the member if made in a later year, to the extent that investment income is earned by the trade association in one year and spent in a later year, the current-law exclusion effectively provides the benefit of a deduction before the expenditure actually is made. (U.S. Department of Treasury, *General Explanations of the Administration's Revenue Proposals*, (February, 1999), at p.60).

Based on this rationale, it is the Administration's view that the UBIT should be used to eliminate the ability of members of 501(c)(6) organizations to leverage their dues by overpaying them in order to accumulate earnings on a tax-free basis—regardless of the purpose for which these earnings are accumulated. Assuming for the moment that this leveraging actually occurs, it would be an expansion of the UBIT beyond the purpose for which it was created and impose it on a 501(c)(6) organization's earnings used in furtherance of its tax-exempt purpose. The UBIT was created to prevent tax-exempt entities from competing unfairly with taxable businesses (e.g., the sort of competition that, nevertheless, exists between credit unions and commercial banks and thrifts). The legislative history makes clear that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of [section 501(c)] organizations enables them to use their profits tax-free to expand operation, while their competitors expand only with the profits remaining after taxes." (H.R. Rep. No. 81–2319, 81st Cong., 2d Sess. 36–37 (1950) and S. Rep. No.81–2375, 81st Cong., 2d Sess. 28–29 (1950)). The same legislative history also makes clear that investment earnings used to advance the tax-exempt purpose are not to be subject to the UBIT "because they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income" (H.R. Rep. No. 81–2139 at 36–38; S. Rep. No. 81–2375 at 30–31).

The investment earnings of 501(c)(6) organizations are used to fund research, educational, and charitable activities—in short, all of the activities that serve the 501(c)(6) organization's tax exempt purpose. The reasons for granting an exemption for investment income from UBIT are as valid today as they were fifty years ago. The Administration is able to point to nothing that has changed since the creation of the UBIT such that Congress should reverse the policy decision it made at that time.

While the investment earnings of 501(c)(6) organizations are in the end used directly to further their tax-exempt functions, the maintenance of a capital reserve is a budgetary necessity to provide for unanticipated costs and avoid a financial crisis. Taxing these reserves will reduce the ability of a 501(c)(6) organization to plan for the future performance of its tax-exempt purpose. Dues income may fluctuate from one year to the next and 501(c)(6) organizations do not have the same access to the credit markets as regular corporations.

The implication of the Administration's rationale is that 501(c)(6) members are prepaying their dues because it is more advantageous for the 501(c)(6) organization to accrue the earnings on the excess dues payment. In effect, the tax-exempt status of the 501(c)(6) organization can be used to create an economic benefit for the members. This would certainly be news to the members. In most cases the members of a 501(c)(6) organization prefer to review annually the value of their membership and would not be interested in prepaying dues. In addition, the same need to assure future liquidity in their own businesses would constrain an overpayment of dues.

In any case, the Administration's economic benefit theory is fallacious. The reserves of a 501(c)(6) organization are almost always invested in the most conservative instruments. Very few members are likely to believe that they could not get a better return on these funds in their own businesses and it is likely that a failure to do so in their own businesses could mean liquidation or unemployment. Moreover, a conscious attempt to implement this economic theory would require a complex dues formula to prevent some members from overpaying dues based on their loss of investment opportunity relative to other members.

The Treasury concedes that a tax on the investment income of a 501(c)(6) organization would require it to raise its membership dues, with the result that the increased UBIT revenue would be significantly offset by a deductible business expense. It appears, however, that, in the view of Treasury, matching the year of the UBIT and the dues deduction, in addition to generating revenue by eliminating the "float," is theoretically preferable.

The failure of the Administration to include the investment earnings of labor unions, which are tax-exempt under section 501(c)(5), in its proposal raises the issue of whether the proposal is politically motivated. Labor unions generally support Democrats; chambers of commerce, included in section 501(c)(6), generally favor Republicans. Both 501(c)(5) and 501(c)(6) organizations advance comparable goals and Congress has, thus far, determined that both should receive similar tax treatment. A Treasury official reportedly attempted to make a distinction on the basis that union members generally claim the standard deduction on their returns, while most members of 501(c)(6) organizations claim a business expense deduction. The fact that someone chooses to take the standard deduction because it produces a greater tax benefit than claiming an employee business expense does not eliminate the comparability of dues paid to 501(c)(5) and 501(c)(6) organizations. Moreover, not all union members, such as those belonging to the Screen Actors and Writers Guilds and the Airline Pilots Association in many cases, take the standard deduction. Not all members of 501(c)(6) organizations are able to deduct their dues because of the limitation on the deductibility of employee business expenses nor can they have their employers reimburse them.

For all of the foregoing reasons ACB strongly urges the Committee to reject the Administration's proposal to tax the investment earnings of 501(c)(6) organizations.

Corporate Tax Shelters

The Administration has proposed a multifaceted and broad-based attack to eliminate what it deems to be abusive "tax shelters." Unfortunately, the definitions used are so vague and encompassing and the penalties prescribed are so draconian that the enactment of these proposals would have a chilling effect on many legitimate transactions. The individual components of the Administration's tax shelter attack will be discussed in the order presented in the budget proposal.

1. Modify substantial understatement rule for corporate tax shelters.

The Administration is proposing to double the substantial understatement penalty for corporate taxpayers from 20percent to 40 percent for any item attributable to a "corporate tax shelter." A corporate tax shelter under the proposal would be "any entity, plan, or arrangement (to be determined based on all facts and circumstances)) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction." A "tax benefit," according to the proposal, would "include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code)." A "tax avoidance transaction" is defined "as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits ... In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income."

Simply presenting its definitions makes apparent how troubling the proposal is. As is apparent from the definitions, IRS agents would be empowered to recommend draconian penalties on the basis of very subjective determinations. It is disconcerting to think that the Treasury will be defining by regulation such potentially broad terms as "transaction," "reasonable expectation," and what is an "improper elimination or significant reduction of tax on economic income" in the context of "tax avoidance transaction."

Most troubling is the alternative definition of a tax avoidance transaction. It could possibly include virtually any transaction that an IRS agent chooses. In addition, it appears that existing precedents and defenses otherwise available to taxpayers to defend the legitimacy of a transaction may not be available under this definition. To combine a definition of such breadth and subjectivity as the alternative with a doubling of the substantial underpayment penalty is to create an enormous potential for IRS abuse. The threat of raising the tax avoidance issue would give IRS agents enormous leverage to force concessions on other items in dispute, apart from the direct impact of the provision.

2. Deny certain tax benefits to persons avoiding income tax as a result of tax-avoidance transactions.

The Administration is proposing to expand the scope of section 269 of the Code by adding a provision authorizing the disallowance of any deduction, credit, exclusion, or tax benefit obtained in a tax avoidance transaction. Under current law, section 269 provides that where a person gains control of a corporation or a corporation acquires carryover basis property and the *principal purpose* of the acquisition is the evasion or avoidance of federal income tax by creating a deduction, credit, or other tax benefit, the benefit may be disallowed to the extent necessary to eliminate the evasion or avoidance.

Once again, the Administration proposes the creation of punitive provision whose breadth and scope is breathtaking. Essentially, any corporate acquisition resulting in "an improper elimination or significant reduction of tax on economic income" could have any of the resulting tax benefits denied by the IRS. According to the Administration, the IRS should be given the statutory right to restructure any corporate acquisition where, in the IRS view, the taxpayer has obtained too much tax benefit.

3. Deny deductions for certain tax advice and impose an excise tax on certain fees received.

Under current law, fees paid by corporations for tax advice are deductible as an ordinary and necessary business expense. The Administration is seeking to eliminate the deductibility of fees *paid* by corporations for advice with respect to the purchase and implementation of "tax shelters" or related to "tax shelters." The proposal would also impose a 25 percent excise tax on fees *received* with respect to corporate tax shelter advice and related to implementing corporate tax shelters (including underwriting fees). If a taxpayer claims a deduction for a fee, whose deductibility is eliminated by this proposal, that deduction would be subject to the substantial underpayment penalty.

This is a singularly insidious proposal because it is doubly punitive and because the chilling effects of the ambiguities within the term "tax shelter" would impact both the corporate client and its professional advisers. Many legitimate transactions may not be done or may be done only after very expensive intellectual agonizing and the imposition of additional risk-based fees. This provision is another indication of the Administration's overreaction to the current marketing of aggressive tax advice by some tax advisers. The Administration has chosen to terrorize corporate America with a carpet bombing campaign to eliminate the threat of tax shelters, instead of using the perfectly adequate weapons of current law to surgically attack the problem.

4. Impose excise tax on certain rescission provisions and provisions guaranteeing tax benefits.

The Administration would impose on corporations an excise tax of 25 percent on the maximum payment under a recession or insurance agreement entered into in connection with a corporate tax shelter. The maximum payment would be the aggregate amount the taxpayer would receive if the tax benefits of the corporate tax shelter were denied. The Treasury report states that if, for example, the taxpayer pays $100 for a guarantee of the tax treatment of a transaction and the tax benefits are valued at $10,000 under the guarantee, the taxpayer would owe an excise tax of $2,500 automatically even if the IRS subsequently denies only $5,000 of the tax benefits.

This is another purely punitive provision and it will also have the effect of disrupting legitimate business transactions and relationships. Ironically, it differs from the previous proposals in that a punitive tax would be imposed in the situation where a tax adviser is sufficiently confident that he has provided sound tax advice that he is willing to stand behind it with a guarantee.

It is the strongly held view of ACB that the foregoing provisions could add significant cost and compliance burdens to an already overly complex tax burden faced by our members. The definitions are ambiguous and overly broad and ACB is concerned that this approach may be intentional. ACB is concerned that the Administration may intend these provisions to have a chilling effect on aggressive tax planning at its inception. Such an intention, if it were to exist, would amount to virtual tax terrorism. The Administration already has an array of effective Code provisions and court precedents to combat tax shelters and we urge the Committee to reject these ill-considered proposals.

Once again, Mr. Chairman, ACB is grateful to you and the other members of the Committee for the opportunity you have provided to make our views known on the Administration's tax proposals. If you have any questions or require additional information, please contact Jim O'Connor, Tax Counsel at ACB, at 202–857–3125.

Statement of American Bankers Association

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on certain of the revenue provisions of the Administration's fiscal year 2000 budget.

The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The Administration's Fiscal Year 2000 budget proposal contains a number of provisions of interest to banking institutions. Although we would welcome certain of those provisions, we are once again deeply concerned with a number of the Administration's revenue raising measures. Many of the subject revenue provisions are, in fact, thinly disguised tax increases rather than "loophole closers." As a package, they could inhibit job creation and inequitably penalize business. The package may also lead to the reduction of employee and retiree benefits provided by employers.

Our views on the most troubling provisions are set out below.

REVENUE INCREASE MEASURES

MODIFY THE CORPORATE-OWNED LIFE INSURANCE RULES

The ABA strongly opposes the Administration's proposal to modify the corporate-owned life insurance rules. We urge you not to enact any further restrictions on the availability of corporate owned life insurance arrangements. We believe that the Administration's proposal will have unintended consequences that are inconsistent with other congressional policies, which encourage businesses to act in a prudent manner in meeting their liabilities to employees. Corporate owned life insurance as a funding source has a long history in tax law as a respected tool, and its continued use was effectively ratified by the Tax Reform Act of 1997. In this connection, taxpayers have, in good faith, made long term business decisions based on existing tax law. They should be protected from the retroactive effects of legislation that would result in substantial tax and non-tax penalties.

Moreover, federal banking regulators recognize that corporate-owned life insurance serves a necessary and useful business purpose. Bank regulatory guidelines confirm that purchasing life insurance for the purpose of recovering or offsetting the costs of employee benefit plans is an appropriate purpose that is incidental to banking.

The subject provision would effectively eliminate the use of corporate owned life insurance to offset escalating employee and retiree benefit liabilities (such as health insurance, survivor benefits, etc.). It would also penalize companies by imposing a retroactive tax on those that have purchased such insurance. Cutbacks in such programs may lead to the reduction of benefits provided by employers. We urge you to, once again, reject this revenue proposal.

S CORPORATIONS—REPEAL SECTION 1374 FOR LARGE CORPORATIONS

The ABA opposes the proposal to repeal Internal Revenue Code section 1374 for large S corporations. The proposal would accelerate net unrealized built-in gains (BIG) and create a corporate level tax on BIG assets while also creating a shareholder level tax with respect to their stock. The BIG tax would apply to gains attributable to assets held on the first day, negative adjustments due to accounting method change, intangibles such as core deposits and excess servicing rights and recapture of the bad debt reserve.

Financial institutions have only recently been allowed by Congress to elect subchapter S status. Effectively, this proposal would close the window of opportunity for them to elect sub S by making the cost of conversion prohibitively expensive for the majority of eligible banks, which we believe is contrary to congressional intent. We urge you to reject the Administration's proposal and to enact legislation that would assist community banks in qualifying under the current rules.

INCREASED INFORMATION REPORTING PENALTIES

The ABA strongly opposes the Administration's proposal to increase penalties for failure to file information returns. The Administration reasons that the current penalty provisions may not be sufficient to encourage timely and accurate reporting. We disagree. The banking industry prepares and files a significant number of information returns annually in good faith for the sole benefit of the Internal Revenue Service (IRS). The suggestion that the Administration's proposal closes "corporate loopholes" presumes that corporations are noncompliant, a conclusion for which there is no substantiating evidence. Further, there is no evidence available to support the assertion that the current penalty structure is inadequate. Certainly, the proposed increase in penalty is unnecessary and would not be sound tax policy. We urge you to once again reject this revenue proposal.

SUBSTANTIAL UNDERSTATEMENT PENALTIES

The ABA opposes the Administration's proposals to modify the substantial understatement penalty. The proposed increases would be overly broad and would penalize innocent mistakes and inadvertent errors. The establishment of an inflexible standard would effectively discourage legitimate "plain vanilla" business tax planning. We urge you to reject this revenue proposal.

ELIMINATE DIVIDENDS-RECEIVED DEDUCTION FOR CERTAIN PREFERRED STOCK/ MODIFY THE RULES FOR DEBT-FINANCED PORTFOLIO STOCK

The ABA strongly opposes the Administration's proposals to deny the dividends-received deduction for non-qualified preferred stock and to modify the standard for determining whether portfolio stock is debt financed. The Administration states that taxpayers have taken advantage of the dividends received deduction for payments on instruments that economically appear to be more akin to debt. We disagree. The ABA, along with other members of the financial services community, has steadfastly opposed all attempts to further limit the dividends received deduction.

The dividends-received deduction currently reduced the impact of the multiple level taxation of earnings from one corporation paid to another and should not be considered a "corporate loophole." Eliminating the deduction for certain preferred stock would create a multiple level corporate tax with respect to such stock. We urge you to oppose the Administration's proposal.

The proposal to modify the rules for debt-financed portfolio stock should also be rejected. In an attempt to tighten the "directly attributable" standard, the Administration proposes a pro rata formula that would be overly inclusive and would effectively eliminate the dividends received deduction for financial institutions.

Additionally, the subject proposals would also effectively increase state tax liabilities for institutions that file separate state tax returns with respect to subsidiaries operating in certain states as the federal taxable income amount is used in calculating state tax liabilities. We strongly urge that these proposals be rejected.

EXPAND REPORTING OF CANCELLATION OF INDEBTEDNESS INCOME

The Administration's budget proposes to require that information reporting on discharges of indebtedness be done by any entity involved in the business of lending money. The ABA opposes this proposal, as it would increase the administrative burdens and costs borne by credit card companies and other financial institutions. We urge you to reject the Administration's proposal.

ENVIRONMENTAL TAXES

The ABA opposes the proposal to reinstate environmental taxes. We believe the burden of payment of the taxes will fall on current owners of certain properties (who may in many instances be financial institutions) rather than the owners at the time the damage occurred. It would, thus, impose a retroactive tax on innocent third parties. In any event, such taxes would be better considered as part of overall program reform legislation. We urge you to reject the Administration's proposal.

Require Current Accrual of Market Discount

The ABA opposes the Administration's proposal to require current accrual of market discount by accrual method taxpayers. This proposal would not only increase administrative complexity but would raise taxes on business unnecessarily. We urge you to reject the Administration's proposal.

Modify Treatment of Start-up and Organizational Expenses

The Administration's proposal would lengthen the amortization period for start-up and organizational expenses in excess of $55,000 from 5 to 15 years. Such change could have a negative impact on the formation of small financial institutions as well as financial services entities, which typically involve start-up costs well in excess of the threshold amount. We urge you to reject the Administration's proposal.

Limit Tax Benefits for Lessors of Tax-Exempt Use Property

The ABA opposes the Administration's actions with respect to tax-exempt use property. Recent IRS action in this area would retroactively impact agreements that were entered into in accordance with the requirements of the Internal Revenue Code. Since this proposal is subject to congressional action, we believe that any change to the current treatment of such transactions should be prospective. We believe action by the Service is not appropriate at this time.

Subject Investment Income of Trade Associations to Tax

The ABA strongly opposes the Administration's proposal to tax the net investment income of trade associations. The proposal would impose a tax on all passive income such as interest, dividends, capital gains, rents, and royalties. It would not only impact national organizations but smaller state and local associations as well. In many instances, dues payments represent a relatively small portion of an association's income. Associations maintain surpluses to protect against financial crises and to provide quality service to members at an affordable cost. Indeed, it is used to further the exempt purposes of the organization.

The Administration's proposal would impose an overly broad, and ill conceived tax on well managed trade associations that would directly affect their ability to continue to provide services vital to their exempt purpose. We urge you to reject the Administration's proposal.

Other Issues

The Administration's proposal contains a number of other provisions, which will negatively impact many different types of appropriate business activities. Some are overly broad, which may have unintended consequences in the long and short term. We strongly urge you to reject the following provisions.

- Extend section 265 pro rata disallowance of tax-exempt interest expense to all corporations
- Modify treatment of ESOP as S corporation shareholder
- Impose excise tax on purchase of structured settlements
- Penalty increases with respect to corporate tax shelters
- Limit inappropriate tax benefits for lessors of tax exempt use property
- Require banks to accrue interest on short-term obligations
- Modify and clarify straddle rules
- Tax issuance of tracking stock
- Modify the structure of businesses indirectly conducted by REITs
- Modify the treatment of closely held REITs
- Deny deduction for punitive damages
- Treat certain foreign-source interest and dividends equivalents as U.S.-effectively connected income
- Recapture overall foreign losses when controlled foreign corporation stock is disposed
- Increase section 4973 excise tax on excess IRA contributions

The impact of the above provisions will affect businesses in various ways, depending upon their structures. Some of the consequences are foreseeable; others are unforeseeable. One result may be a restriction or change in products and services provided to consumers. Another may be a restriction on the ability of financial institutions to compete globally.

TAX INCENTIVE PROPOSALS

EDUCATIONAL ASSISTANCE

The ABA supports the permanent extension of tax incentives for employer provided education. The banking and financial service industries are experiencing dramatic technological changes. This provision will assist in the retraining of employees to better face global competition. Employer provided educational assistance is a central component of the modern compensation package and is used to recruit and retain vital employees.

RESEARCH AND EXPERIMENTATION TAX CREDIT

The ABA supports the permanent extension of the tax credit for research and experimentation. The banking industry is actively involved in the research and development of new intellectual products and services in order to compete in an increasingly sophisticated and global marketplace. The proposal would extend sorely needed tax relief in this area.

INDIVIDUAL RETIREMENT ACCOUNTS

The ABA fully supports efforts to expand the availability of retirement savings. We are particularly pleased that the concept of tax-advantaged retirement savings has garnered long-standing bi-partisan support and that the Administration's plan contains many significant proposals to encourage savings.

LOW-INCOME HOUSING TAX CREDIT

The ABA supports the proposal to raise the $1.25 per capita cap to $1.75 per capita. This dollar value has not been increased since it was first set in the 1986 Act. Raising the cap would assist in the development of much needed affordable rental housing in all areas of the country.

QUALIFIED ZONE ACADEMY BONDS

The ABA supports the proposal to authorize the issuance of additional qualified zone academy bonds and school modernization bonds and to modify the tax credit bond program. The proposed changes would facilitate the usage of such bonds by financial institutions in impacted areas.

CONCLUSION

The ABA appreciates having this opportunity to present our views on the revenue raising provisions contained in the President's fiscal year 2000 budget proposal. We look forward to working with you in the future on these most important matters.

Statement of American Council of Life Insurance

The American Council of Life Insurance (ACLI) is strongly opposed to the totally unwarranted $7 billion tax increase on life insurance companies and products in the Administration's Fiscal Year 2000 Budget Proposal. As 31 members of this Committee have already recognized, these proposals would seriously threaten the hopes of millions of Americans for a financially secure retirement and jeopardize the financial protection of families, businesses and family farms.

The Council is pleased to provide this statement representing, for the first time in twenty years, a life insurance industry fully united on all tax issues affecting our industry. For many years we have been told by members of this Committee that the industry's voice on tax issues is weakened by the disagreements among the stock and mutual segments. Last month, however, there was an historic change—the end of the long-standing stock and mutual differences. With one voice now, the Council declares that there is no justification for provisions of the Code that separately tax stock and mutual life companies. With one voice now, the Council opposes any increase in taxes on any industry segment. With one voice now, the Council demonstrates that our industry already pays more than its fair share of taxes, and the Administration's proposals are both totally unjustified and bad tax policy. We are also pleased that the National Association of Life Underwriters supports the Council in this statement.

The nearly 500 company members of the ACLI offer life insurance, annuities, pensions, long term care insurance, disability income insurance and other retirement and financial protection products. Our members are deeply committed to helping all Americans provide for a secure life and retirement.

Two of the proposals in the Fiscal Year 2000 Budget Proposal would make annuities and life insurance more expensive for individuals and families struggling to save for retirement and protect against premature deaths. Annuities are the only financial product that provides guarantees against outliving one's income. Life insurance is the only product that gives security to families should a breadwinner die prematurely. Another proposal could wipe out a financial product that protects businesses and allows them to provide employee benefits, including retiree health benefits.

The proposals do not make sense, and represent a retreat by the Administration from its stated goal of encouraging all Americans to take more personal responsibility for their income needs in retirement and at times of unexpected loss. They also seem to reflect a failure to understand the important role life insurance products play in the retirement and protection plans of middle-income Americans. ACLI member companies strongly support fixing Social Security first, but they are convinced that it will be impossible to reach this goal in the absence of a strong and vital private retirement and financial security system. Tax proposals that weaken that system are misguided and contradictory.

Contrary to the Administration's perception, life insurance companies already pay federal taxes at a rate which is significantly higher than the rate for all U.S. corporations. Additional federal taxes would unfairly increase that already high tax burden. A recently completed study by Coopers & Lybrand shows that life insurers paid $54.4 billion in Federal corporate income taxes from 1986–1995. The average effective tax rate for U.S. life insurers over that ten year period was 31.9%, significantly higher than the 25.3% average effective rate for all U.S. corporations. Moreover, the effective rate rose sharply during the ten-year study period, from 23.9% between 1986 and 1990, to 37.1% between 1991 and 1995, with the imposition of the DAC tax in 1990 (described below).

The Administration Budget Proposal for Fiscal 2000 contains many unwarranted tax increases on life insurance products, policyholders and companies. The major increases include:

PROPOSAL TO INCREASE DAC TAX ON ANNUITIES AND LIFE INSURANCE

In addition to paying regular corporate income taxes, life insurers must pay a tax based on gross premiums from the sales of their products, including life insurance and annuities. This tax is known as the DAC tax. This new tax was imposed in 1990 to serve as a proxy for the amount of expenses life companies incur to put life and annuity policies on their books. Under the DAC tax, these expenses are no longer tax deductible in the year paid; rather the deduction is spread over a ten year period. (The acronym DAC stands for deferred acquisition costs.) The DAC tax is an arbitrary addition to corporate income tax calculated as a percentage of the net premiums attributable to each type of policy. It was not logically defensible in 1990, and is not now. The Administration proposes to triple the DAC tax on annuities, nearly double the tax on individual whole life insurance, raise the tax on group whole life six-fold and also increase other DAC taxes.

ACLI RESPONSE:

• An Increase in the DAC Tax on Annuities and Life Insurance Would Make Important Protection and Retirement Savings Products More Expensive. Today Americans are living longer than ever before and our aging population is putting more pressure on already-strained government entitlement programs. Consequently, individuals must take more responsibility for their own retirement income and protection needs. Adding taxes based on the premiums companies receive for retirement and protection products will lead directly to higher prices and undermine Americans' private retirement and protection efforts.

• The Administration Proposal Represents a Thinly Disguised Tax Increase on Policyholders and an Attack on Inside Build-up. The proposed DAC tax increase falls principally on annuities and whole life insurance, both individual and group. These are the products that allow policyholders to accumulate earnings to fund the costs of insurance in the later, more expensive years of the policy. The inside build-up is taxed if cash is withdrawn from the policy. This tax treatment represents sound social and tax policy designed to encourage individuals to purchase these important retirement and protection products. The increase in the DAC tax on annuities and whole life insurance is an attempt to tax indirectly the policyholders' inside build-up on these products, contrary to sound tax policy. The tax will certainly have that effect on policyholders through increased costs and lower returns.

• The Tax System Prior to Enactment of the 1990 DAC Tax Already Deferred Life Insurers' Deductions for Acquisition Costs through Reduced Reserve Deductions. It is Inappropriate to Further Extend this Unfair "Double Deferral" Scheme. In 1984, Congress reduced companies' reserve deductions by a formula that effectively defers deductions for policy acquisition costs. Thus, the DAC tax was unnecessary in 1990 and should not be increased in the 21st century. No insurance accounting system (GAAP or state regulatory) requires both the use of low reserves and deferral of deductions for policy acquisition expenses. Treasury specifically cites the GAAP system as a model for requiring deferred deductions for acquisition costs, but ignores the fact that GAAP does not also require reduced reserve deductions.

PROPOSAL TO TAX POLICYHOLDERS SURPLUS ACCOUNTS

Prior to the Tax Reform Act of 1984, shareholder-owned life insurance companies established policyholders surplus accounts (PSAs), reflecting a portion of their operating gains that were not subject to tax. PSA amounts would be taxed only if such amounts were deemed distributed to shareholders or the company ceased being a life insurance company. In 1984, Congress completely rewrote the structure of taxation of life insurance companies to tax them on a comprehensive income basis. As part of that thorough rewrite, Congress decided to eliminate further additions to PSAs. Congress also concluded that the shareholder distribution trigger for taxing PSAs would be maintained. The Administration now proposes to force life companies to include these tax accounts in income and pay tax on the PSA over a ten year period.

ACLI RESPONSE:

• The Administration Proposal Is a Retroactive Tax and a Violation of Fair Tax Treatment. To reach back for tax revenues on long-past operating results, some from nearly 40 years ago, is wrong. Congress addressed the tax treatment of policyholders surplus accounts 15 years ago. In fact, the Committee Reports to the 1984 Tax Reform Act specifically provide that life insurance companies "will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules comparable to those provided under the 1959 Act." Such arbitrary efforts to retroactively change the tax rules applicable to old operations reveals a desperate revenue grab by Treasury.

• The Administration Proposal Inappropriately Resurrects Tax Code Deadwood. The policyholders surplus account (Section 815 of the tax code) is merely a tax accounting mechanism or record in the practical operations of life insurance companies. There are no special untaxed assets set aside in a vault available to pay this unanticipated tax. In fact, the accountants have concluded that under state statutory and GAAP accounting rules that govern shareholder-owned life insurance companies, Section 815 accounts would very rarely, if ever, be triggered, and, if so, would be triggered only by activities under the control of the taxpayer. Thus, statutory and GAAP accounting conclude that the potential tax liability under Section 815 should be disregarded for accounting purposes. No one could conceive that Treasury would resurrect this deadwood. Only now, when Treasury needs to fill out its budget, is the deadwood brought to life.

• The Administration Proposal Creates Immediate Full Loss of Shareholder Value, in Addition to Tax Hit. Should this proposal become law, shareholder-owned life insurance companies would be hit first when forced to pay tax over a ten-year period out of the earnings and assets that would otherwise be used to do business and protect policyholders. The companies would also be forced to record immediately the new, full tax liability on their public accounting reports to shareholders. This creates an immediate loss to shareholders of the entire amount of the new tax, not just the first year payment.

• The Administration Reasoning Relating the PSAs to Specific Policies is Specious. There is not now, and never has been, any relationship between liabilities under specific policies and additions to PSAs that took place prior to 1984. Thus, Treasury is disingenuous when it suggests that taxing PSAs now would cause no harm to policyholders from a past era. What the new tax will do is affect the return to current policyholders since this is a tax that must be paid from current operations.

PROPOSAL TO TAX BUSINESS LIFE INSURANCE

In 1996, Congress eliminated the deductibility of interest paid on loans borrowed directly against business life insurance (policy loans), except in very limited circumstances involving grandfathered policies and policies covering key individuals. In 1997, Congress further limited deductions for interest on unrelated business borrowing if the business owns life insurance. This most recent tax penalty does not apply to contracts covering employees, officers, directors and 20-percent owners. The Administration now proposes to place an additional tax on companies that borrow for any purpose if those companies also own life insurance, including key employee insurance. The proposal would also increase taxes on companies that borrow directly against life insurance policies covering key employees. This proposal would destroy the carefully crafted limitations created in the 1996 and 1997 legislation by eliminating most key persons as defined in the 1996 Act and eliminating employees, officers and directors from the 1997 Act provisions.

ACLI RESPONSE:

Further changes in the tax treatment of business life insurance are unnecessary and would unfairly disrupt the fundamental protection and benefit plans of many businesses. Far from a "tax shelter" as Treasury contends, business life insurance is a product that protects businesses, especially small businesses, and allows all businesses to provide employee benefits, including retiree health benefits. The proposal would eliminate the use of business life insurance in providing those protections and benefits.

- The Proposal Is Anti-Business Expansion. Under the proposal, the mere ownership of a whole life insurance policy on the president of a company could result in additional tax to that company. This additional tax would be imposed against loans that bear no relation to any borrowing from the life insurance policy, but rather would result from normal business borrowing for expansion and similar fundamental purposes. There is no good reason why the mere ownership of a policy on the employees, directors or officers of the firm should result in a tax penalty on unrelated borrowing. The businesses affected by this proposal will have to choose between protecting themselves against the premature death of a valued employee, officer or director, and borrowing to increase their business. This forced choice between valid, unrelated business needs is bad tax and economic policy.
- Key Person Direct Borrowing Exception Is Important. In 1996, Congress reviewed the taxation of policy loans borrowed directly from life insurance policies. As a result of this review, substantial restrictions were placed on this borrowing, limiting it to coverage on a small number of key employees. The present proposal ignores this review and crafts new and more draconian limitations. There is no rationale for changing from the 1996 legislation to the current proposal. The key person exception is especially important to allow small businesses access to their limited assets.
- Mere Ownership Of A Policy On An Employee, Officer Or Director Should Not Result In A Tax Penalty. In 1997, Congress reviewed the taxation of borrowing unrelated to life insurance policies where the business also happened to own life insurance. As a result of this review, a tax penalty was imposed on companies that have loans unrelated to the life insurance policy if the policy covers customers, debtors and other similar insureds. Coverage of employees, officers, directors and 20-percent owners was specifically exempt from this penalty. There is no rationale for changing from the 1997 legislation to the current proposal under which policies on employees, officers and directors can result in a tax penalty. Protection of valuable workplace human capital assets is crucial to business and should not be penalized.
- Protecting Against Loss Of Valuable Employees Is Fundamental To Business Operations. Just as businesses rely on insurance to protect against the loss of property, they need life insurance to minimize the economic costs of losing other valuable assets, such as employees. This is especially important with respect to small businesses, the survival and success of which often rest with their key employees. Without access to permanent life insurance at a reasonable cost, companies may not have the capital necessary to keep operations afloat after the loss of such assets. The proposal can well make that cost in excess of what a business can afford.
- Businesses Need Employee Coverage To Fund Retiree Benefits. Corporations frequently use life insurance as a source of funds for various employee benefits, such as retiree health care. Permanent life insurance helps make these benefits affordable. Loss of interest deductions on unrelated borrowing is an inappropriate tax penalty that will force these companies to reduce employee and retiree benefits funded through business life insurance.

• The Administration "Arbitrage" Reasoning is Specious and Masks an Unwarranted Attempt to Tax Inside Build-Up. Any further tax changes to business life insurance target the current treatment of inside build-up on permanent life insurance. The effect of denying general interest deductions by reference to the cash value of life insurance is to tax the cash value build-up in the permanent policy. Allowing general business interest deductions to accompany mere ownership of life insurance cash values does not represent tax arbitrage and is fully consistent with general tax and social policy. For example, a business that uses commercial real estate as collateral for a loan does not lose the deduction of loan interest even though the property's value consists of appreciation and even though the tax on that appreciation is deferred until the property is sold. Additionally, the rate of tax on any gain is the lower capital gains rate. Similarly, other business tax benefits, such as the research and development tax credit, do not result in a loss of interest deductions when a firm borrows for normal business purposes. The Administration's arbitrage reasoning is plainly inappropriate because if applied to an individual it would cause the loss of home mortgage interest deductions when a taxpayer also owns permanent life insurance.

Statement of American Insurance Association

INTRODUCTION

The American Insurance Association (AIA) is a national trade association representing more than 300 major insurance companies that provide all lines of property and casualty (P&C) insurance nationwide and globally.

AIA appreciates having this opportunity to comment on the revenue proposals in the Administration's' fiscal year 2000 budget. AIA's concerns with these proposals can be grouped into three categories, as follows:

• P&C insurer-targeted proposal (i.e., increasing the "proration" of tax exempt interest and certain dividends received by P&C insurers from 15% to 25%);

• Broader proposals opposed by AIA (i.e., reinstating Superfund excise taxes and corporate environmental income tax (EIT); requiring the current accrual of market discount; denying a deduction for punitive damages; increasing information reporting penalties; taxing the investment income of section 501(c)(6) trade associations); and

• Tax changes supported by AIA (i.e., extending the active financing income exception; imposing the excise tax on structured settlements).

These comments principally address the adverse impacts of the "proration" proposal, which is targeted at P&C insurers (and, indirectly, the exempt bond market in which they participate). However, AIA feels no less strongly about its positions, described below, on extending the active financing income exception, which otherwise will sunset this year, and reinstating Superfund taxes.

In addition, AIA feels strongly, from an association perspective, that it is time to put to rest for good the proposal to tax the investment income of trade associations, which was rejected by Congress in 1987.

P&C INSURER-TARGETED PROPOSAL

Proration of Tax Exempt Interest and Dividends Received

As part of its fundamental overhaul of the tax rules governing P&C insurers, Congress in 1986 adopted the "proration" rule, effectively taxing a portion of P&C insurers' exempt interest and dividend income.[1] Congress fixed this portion at the 15% level to generate additional taxable income from P&C insurers, while maintaining such insurers as viable investors in the market for municipal bonds.[2] This purpose was reaffirmed, in effect, when Congress excluded insurers from a proposal in 1997 to disallow an interest expense deduction with respect to a pro rata portion of municipal bond earnings.[3]

[1] P&C insurers are major holders of tax-exempt municipal bonds. In 1997, P&C insurers held some $180 billion (almost 14%) of the total $1.3 trillion of outstanding exempt bonds.

[2] These bonds—a vital source of capital for state and local governments—are used to finance new public school construction, build bridges, roads, and water and sewer systems, airports, and for a variety of other traditional public uses.

[3] The exemption is included in the pro rata interest disallowance rule included in the Administration's fiscal year 2000 budget.

Last year, the Administration unsuccessfully sought to double the tax on exempt interest received by P&C insurers. Treasury's stated rationale was that P&C insurers should be treated more like other financial intermediaries, whose ability to purchase municipal bonds already had been, as Treasury stated, "severely curtailed or eliminated." The Administration, presumably persuaded last year that 30% proration would have unacceptable impacts on the municipal bond market, now proposes instead to hike P&C insurer proration to 25%. This proposal would be effective with respect to investments acquired on or after the date of first committee action.

Last year, AIA surveyed its membership to assess the impacts of adopting the Administration's proration proposal. Respondents to the survey, comprising almost 20% of total P&C insurance industry premium volume and collectively holding almost $39 billion of municipal bonds, confirmed that they would buy fewer municipal bonds if the proposal was adopted, unless municipal bond yields increased sufficiently.[4] This would, in turn, increase the costs of borrowing for state and local issuers and the tax burden on state and local taxpayers, with no discernible tax policy or public policy benefits. Indeed, it was estimated last year that 75% of the total additional taxes raised by the proration proposal would have been borne by state and local governments, and ultimately taxpayers, in the form of increased municipal bond yields.[5]

It is obvious that a P&C insurer will not invest in a municipal bond unless the investment yields a greater after-tax return than a taxable bond. As a matter of arithmetic, this "breakeven" ratio, now 68.6%, would rise to 71.2% (relative to U.S. Treasury securities) if the 25% proration proposal were adopted. This already is perilously close to the typical market yield spreads between exempt and taxable bonds, particularly in the typical "P&C maturity range" (i.e., 10 to 20 years maturity). As a practical matter, however, a P&C insurer will invest in a municipal bond only when this yield ratio is sufficiently in excess of this breakeven ratio to take account of the significant risk premium that the municipal bond carries. This risk premium arises from a number of liquidity, tax and business risks, including the following:

- Alternative investments. Even now, the municipal bond market is illiquid relative to the markets for higher-yielding, taxable P&C investments.
- Capital gains rates. Reduced individual capital gains rates have increased the attractiveness of equities for these investors, further narrowing liquidity in the exempt bond market.
- "Grandfathered" bonds. P&C insurers would be reluctant to sell current exempt bond holdings, "grandfathered" under the proration proposal, significantly narrowing liquidity in the exempt market.
- Alternative buyers. Current tax rules make it uneconomic, in general, for a P&C to invest in municipal bonds at the shorter end of the maturity curve. If a P&C insurer's costs increase in the P&C maturity range, where support from retail investors and mutual funds is only occasional, it is unclear that there would be any alternative market in this range.
- Regular tax rates. Corporate tax rates have fluctuated widely over the past 10 to 15 years. The possibility of reduced marginal tax rates is a significant risk factor for a P&C insurer investing in a municipal bond in the P&C maturity range.
- Shifting proration rules. A P&C investor cannot ignore the risk that the market will perceive the 25% proration proposal as the latest in a series of continuing attempts to erode the value of exempt interest, demanding an additional risk premium across all sectors of the exempt market.
- Tax restructuring. A P&C insurer purchasing a municipal bond in the P&C maturity range, even today, cannot ignore the risk that fundamental tax restructuring (e.g., a flat tax, or national sales tax replacing the federal income tax) might eliminate any tax incentive to hold such bonds.
- Alternative minimum tax (AMT). For a P&C insurer, adverse loss experience, including a single major catastrophic event (e.g., Hurricane Andrew, the Northridge Earthquake), can readily and dramatically change assumptions about underwriting results. Where adverse underwriting results give rise to liability for the AMT, a P&C insurer faces a significant penalty on tax-exempt interest.[6]

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[4] A P&C insurer must match its investments with its liabilities, so that the increased yield that such an insurer would need to invest in municipal bonds under 25% proration, typically would not be realized by changing the duration of the insurer's investment portfolio.

[5] Municipal Market Comment, Friedlander & Mosley (Salomon Smith Barney, February 6, 1998).

[6] Exempt interest is now taxed to a P&C insurer at an effective rate of 15.75%, well above the 5.25% effective tax rate under the regular tax. While AMT credits may mitigate this penalty, they do not eliminate it.

• State tax. Most states do not subject P&C insurers to state income tax. Such insurers are subject instead to a premium tax, which is a gross receipts tax on total direct premiums received by the insurer. P&C insurers investing in municipal bonds, in general, will realize reduced yields with no tax benefit at the state level.

These risk factors increase significantly above the "arithmetic breakeven ratio" the market yield ratio that a P&C investor must demand to purchase a municipal bond. As a result, if proration increases, a P&C insurer would invest in a municipal bond in the P&C maturity range only if yields increased significantly (e.g., by an estimated 10 to 15 basis points, under 30% proration[7]).

Even a small increase in the interest cost to municipal finance would substantially increase the aggregate financial costs to state and local governments of critical debt-financed public works projects. Last year, the Bond Market Association estimated that, if 30% proration had been in effect in 1997, when some $207 billion in tax exempt securities were issued, it would have cost issuers $2 to $3 billion over the life of their issues (assuming an average 15-year maturity).

The proration proposal also would increase the taxation of certain dividends received by a P&C insurer. This would reduce financing options for U.S. companies, increase the costs of capital, and reduce liquidity in domestic capital markets. For these reasons, Congress has wisely rejected other proposals in recent years to increase the taxation of dividends received.

The remaining tax burden of increased proration would be borne by the P&C insurance industry and its policyholders. There is no justification for singling-out this industry, already bearing its fair share of the federal income tax burden, for another tax hike. The 1986 and 1990 tax acts imposed on P&C insurers a number of fundamental, targeted tax law changes that significantly increased this industry's federal tax burden. Studies of the 1986 changes, including Treasury's own study, consistently reflect that the P&C industry has substantially exceeded Congress' revenue expectations. Other changes, including the taxation of municipal bond interest under the AMT, which became more severe in 1990, and the limitation in 1997 of the net operating loss carryback period, further disproportionately burden P&C insurers.

BROADER TAX PROPOSALS

Superfund Taxes

The Administration proposes to reinstate the Superfund taxes that expired on December 31, 1995. However, the authorization for the Superfund hazardous waste cleanup program, which the taxes were intended to finance, expired at the end of 1994, and the Administration has continued to block all Congressional attempts to reauthorize and reform the program. AIA would support the reinstatement of the taxes only as part of comprehensive Superfund reform legislation, and only if revenues from these taxes are used for hazardous waste cleanup, and not to fund unrelated programs.

Market Discount

The Administration proposes to require the current accrual of market discount on debt instruments. The proposal would be effective for debt instruments acquired on or after the date of enactment. P&C insurers must invest in debt securities and equities to back loss reserves needed to meet obligations to policyholders. AIA opposes this proposal because it would impose additional costs and complexity[8] on P&C insurers and their policyholders. Significantly, the proposal would be retroactive, in effect, because it would apply to bonds "acquired" (rather than "issued") after enactment, thereby diminishing the value of a market discount bond in the existing portfolio of an affected P&C insurer.

Punitive Damages

The Administration proposes to deny a deduction in all cases where punitive damages are paid or incurred by the taxpayer. In cases where the liability is covered by insurance, the Administration proposes that the damages must be included in the income of the insured and the insurer must report such amounts to the insured and the IRS.

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[7] Municipal Market Comment, Friedlander & Mosley (Salomon Smith Barney, February 13, 1998).

[8] The complexity of the provision also is a concern reflected in the Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget A Proposal, prepared by the staff of the Joint Committee on Taxation, at 207 (February 22, 1999).

The Administration's proposal appears to assume that punitive damages are generally covered by insurance. As a general rule, however, punitive damages are not (and, in many states, cannot be) covered by insurance.

In the typical civil litigation case, where insurance may cover a settlement payment but not a punitive damages award, this proposal would provide an incentive for a commercial insured to settle, even at a higher amount, in order to avoid the possibility of a punitive damage award. By driving up the cost of settlements, the proposal would increase the costs of insurance.

In the (unusual) case, where punitive damages are covered by insurance, the proposal would impose a new information reporting burden on P&C insurers, who are still struggling (with no regulatory guidance) with the burdens and uncertainties arising under the requirement, adopted in 1997, to report "gross proceeds" payments to attorneys.

Information Reporting Penalties

The Administration proposes to increase the penalties for failures to correctly file certain information returns from $50 per return to the greater of $50 or 5% of the amount required to be reported (subject to certain exceptions). As applied to the millions of Forms 1099-MISC that individual P&C insurers must file for payments to third-party service providers (e.g., auto body repair shops), with whom they typically have no account relationship and no prior dealings, this proposal would impose additional costs with minimal compliance benefits. Moreover, as applied to "gross proceeds" attorney reporting required under the 1997 tax act, imposing this penalty as a percentage of the amount required to be reported (much of which, typically, will be a nontaxable claims payment) would disproportionately burden P&C insurers.[9]

Investment Income Tax on Trade Associations

The Administration proposes to subject the investment income of trade associations to the unrelated business income tax (UBIT). For several reasons, AIA feels that this proposal, wisely rejected by the Congress in 1987, should be firmly repudiated this year.

- If this proposal is adopted, affected trade associations would need to increase member dues to pay the new tax[10] or reduce member services. The proposal would subject to this Hobson's Choice—inexplicably and inequitably—exempt trade associations that lobby, like AIA, but not other exempt organizations that lobby.
- The purpose of UBIT is to avoid unfair competition with respect to for-profit businesses. The taxation of a trade association's passive investment income in no way addresses any issue of competitiveness, however, nor has Treasury even suggested that it does.
- A tax exempt trade association's investment income does not, and cannot, result in private inurement to any private shareholder or individual. Rather, this income is allocated to the association's operating budget, furthering its exempt purposes (i.e., improving the business conditions of a particular line of business).
- For a trade association, which cannot access the capital or credit markets, investment income can serve as a vital buffer against instability during economic downturns. The proposed tax, which would erode this buffer, would perversely penalize associations for taking this prudent step.

TAX CHANGES SUPPORTED BY AIA

Active Financing Income Exception

The Administration's budget proposals provide for the extension of six expiring provisions, but omit the active financing income exception to subpart F of the Internal Revenue Code, which expires at the end of 1999. This provision, which helps to level the playing field with respect to foreign multinational and local country competitors in global markets, is essential to the competitiveness of U.S. insurers seeking to enter or expand in those markets. It also is essential to the equitable tax treatment of U.S. financial services industries relative to other U.S. industries.

AIA endorses H.R. 681, which would achieve a permanent, stable tax regime in this area. AIA agrees with comments on this issue filed with the Committee (and joined in by AIA) by The Coalition of Services Industries. At a minimum, this provi-

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[9] *Id.* at 323.

[10] This would increase the tax deduction taken by members for dues payments, and reduce any revenue raised by the proposal. In this regard, Treasury estimates that this proposal would raise $1.44 billion over five years, while the Joint Committee on Taxation estimates that it would raise $700 million over the same period.

sion should be extended along with other extensions of expiring provisions in the budget bill.

Structured Settlements

The Administration proposes to impose a 40% excise tax on persons acquiring a payment stream (i.e., factoring) a structured settlement. This proposal is similar to bills sponsored this year and last by Rep. Shaw. The staff of the Joint Committee on Taxation has aptly described the value of this proposal, as follows:

> The proposal responds to the social concern that injured persons may not be adequately protected financially in transactions in which a long-term payment stream is exchanged for a lump sum. Transfer of the payment stream under a structured settlement arrangement arguably subverts the purpose of the structured settlement provisions of the Code to promote periodic payments for injured persons.[11]

AIA agrees that this proposal will help to maintain the integrity of the structured settlement process.

CONCLUSIONS

AIA respectfully urges the Committee to reject the Administration's budget proposals to:

- increase the taxation of otherwise tax-exempt income and certain dividends received,
- reinstate Superfund excise taxes and the corporate EIT,
- require the current accrual of market discount on bonds,
- disallow a deduction for punitive damages,
- increase information reporting penalties, and
- tax the investment income of trade associations.

AIA also urges the Committee to extend the active financing income exception under subpart F of the Code, and to adopt the budget proposal to impose an excise tax on the "factoring" of structured settlements.

AIA remains ready to assist the Committee in any way possible to achieve these goals.

Statement of American Network of Community Options and Resources (ANCOR), Annandale, Virginia

This testimony outlines the comments and suggestions of the American Network of Community Options and Resources ("ANCOR") on the Administration's proposal to simplify the foster child definition under the earned income tax credit ("EITC").

Formed in 1970 to improve the quality of life of persons with disabilities and their families by coordinating the efforts of concerned providers of private support services, ANCOR is comprised of more than 650 organizations from across the United States together providing community supports to more than 150,000 individuals with disabilities.

ANCOR supports the underlying goals of the Administration's EITC proposal to clarify the scope of current tax law as it applies to foster families. However, ANCOR also strongly recommends that the proposal be drafted to reflect a proposed amendment to Section 131 of the Internal Revenue Code of 1986, as amended (the "Code"). This amendment would eliminate inequities and uncertainties of current law and uniformly allow foster care providers to exclude from income the foster care payments they receive from a governmental source. ANCOR believes that amending Section 131 in this manner would (i) support State and local government efforts to reduce bureaucracy and costs, (ii) simplify the tax treatment of foster care payments, and (iii) encourage much-needed foster care providers to participate in foster care programs.

DESCRIPTION OF CURRENT LAW AND ADMINISTRATION'S PROPOSAL

I. Current law.

Section 32 of the Code allows a taxpayer to claim the EITC if he or she lives with a child or grandchild for more than half the year. In addition, a taxpayer may claim the EITC if he or she lives with a "foster child." "Foster child" is defined as an indi-

[11] *Id.* at 329.

vidual who lives with the taxpayer for the entire year and for whom the taxpayer cares as such taxpayer's own child. To qualify for the EITC, the individual must be (i) younger than 19 years of age if not a full time student, (ii) younger than 24 years of age if a full time student, or (iii) any age if permanently and totally disabled. Section 32 does not require that a foster child for whom a family takes the EITC be placed in the household by any particular type of foster care agency.

II. Administration's proposal.

For purposes of qualifying for the EITC under Section 32, the Administration proposes defining "foster child" to include, inter alia, children (or disabled individuals) placed in the taxpayer's home by an agency of a State, one of its political subdivisions, or tax-exempt child placement agency licensed by a State. This language tracks the language in Section 131, another Code provision relating to taxation of foster families.

Analysis of the Administration's Proposal

I. The Administration's proposal would help clarify who qualifies for the EITC under Code Section 32.

We believe that clarifying who qualifies as a foster child or individual as suggested by the Administration will help prevent the unintentional mistakes of countless taxpayers who now question whether their situations meet the qualifications of Section 32. Additionally, such clarifying changes would provide qualifying foster care providers with an adequate guarantee of their eligibility to take the EITC. Clarity would also help reduce the expense qualifying foster care providers often incur when they are forced to prove that they have claimed the EITC lawfully. Any such clarifying amendments, however, should parallel those proposed for Section 131, as explained below.

II. Congress should further clarify the tax treatment of foster care payments by amending Code Section 131.

Defining the term "foster child" as it applies to the EITC is only a first step in simplifying the complicated tax rubric associated with the provision of foster care services. Additional changes should be made to Section 131 of the Code, which creates a dichotomy in the tax treatment of foster care providers for individuals under 19 years of age and those who provide treatment to individuals over 19 years of age. These Section 131 changes should also be applied to the treatment of a "foster child" under Section 32.

For children under 19 years old, Section 131 of the Code currently permits foster care providers to exclude foster care payments from taxable income when a government entity or charitable tax-exempt organization directly places the individual and makes the foster care payments. For individuals 19 years of age or older, Section 131 excludes foster care payments from taxable income only when a government entity makes the placement and the payment. Thus, the excludability of foster care payments, even though such payments are derived from government funds, is linked to the type of agency that places the individual with a foster care provider.

This inflexible and dated treatment of taxpayers who provide services to children and special needs individuals has become more evident as foster care placement has developed as a preferred means of service provision to many individuals. In addition to the benefits this form of service produces for special needs individuals, foster homes have proven their efficacy for these individuals when compared to institutional services and are a growing choice of State and local governments. Governmental entities have found that foster care provides better service to certain special needs individuals and is less expensive and onerous for them to maintain. This type of residential alternative also adds to the available stock of community housing and expands the availability of qualified individuals to provide support to both adults and children with disabilities.

A realization that foster care placement is the best solution in certain circumstances, added with a desire to reduce government involvement in the day-to-day placement and service decisions, has resulted in governmental agencies becoming more reliant on private agencies to arrange foster care services for both children and adults. The private sector continues to play an important and growing role on behalf of government by arranging for and supervising these homes through licensing or certification by State or local governments.

Congress should amend Section 131 to allow all foster care providers the ability to exclude from income foster care payments received from a governmental source regardless of whether a governmental entity placed the foster child, as long as a governmental entity has either certified or licensed the placement agency. Amending Section 131 in such a way would not only support the efforts of State and local governments to address the needs of their communities more effectively, but would also simplify the treatment of foster care payments and reduce the administrative burden of the Internal Revenue Service ("IRS").

A. Current law fails to support the decisions of State and local governments.—Governmental entities are becoming increasingly reliant on private agencies to place both children and special needs adults in foster care. In particular, governmental entities have found that foster care for special needs adults reduces the expense that is usually incurred when maintaining group homes and institutional settings. Additionally, State and local governments often use outside entities to make case-specific decisions (such as identification of those individuals who would benefit from foster care and those foster care families with whom such individuals should be placed) as a means of reducing bureaucracy in an already trying situation. Current law, however, fails to provide the same tax treatment to those foster care families identified by private entities acting under a license or certification with States, counties and municipalities as is provided to foster care families that are identified directly by the State. Disparate treatment exists despite the fact that from the governmental entities' perspectives, the activities are the same. As a result of the difference in treatment, State and local governments are discouraged from contracting with private agencies to make placement decisions. The tax code should support State and local governments that decide to cut costs, reduce bureaucracy and support the special needs individuals in their communities through expanding their foster care programs.

B. Current law is confusing to taxpayers and to the IRS.—As illustrated by Table 1, incongruent treatment of foster care providers has created a complex system of determining when providers can exclude their foster care payments from income.

Table 1—Excludability of Foster Care Payments from Income Under Section 131

Placement Agency	Payor	Age of Foster Care Individual	Payment Excludable?
State or political subdivision	State or political subdivision	<19 years	Yes
State or political subdivision	State or political subdivision	≧19 years	Yes
State or political subdivision	501(c)(3)	<19 years	Yes
State or political subdivision	501(c)(3)	≧19 years	No
State or political subdivision	Not 501(c)(3)	<19 years	No
State or political subdivision	Not 501(c)(3)	≧19 years	No
Licensed 501(c)(3)	State or political subdivision	<19 years	Yes
Licensed 501(c)(3)	State or political subdivision	≧19 years	No
Licensed 501(c)(3)	501(c)(3)	<19 years	Yes
Licensed 501(c)(3)	501(c)(3)	≧19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	<19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	≧19 years	No
Not 501(c)(3)	State or political subdivision	<19 years	No
Not 501(c)(3)	State or political subdivision	≧19 years	No
Not 501(c)(3)	501(c)(3)	<19 years	No
Not 501(c)(3)	501(c)(3)	≧19 years	No
Not 501(c)(3)	Not 501(c)(3)	<19 years	No
Not 501(c)(3)	Not 501(c)(3)	≧19 years	No

The confusion presented by current law was exemplified by the recent decision in Micorescu v. Commissioner, T.C. Memo 1998–398. In Micorescu, the Tax Court held that an Oregon family providing foster care services to adults in the family's home could not exclude from income payments received from the private agency that placed the foster individuals with the family. The court reasoned that because the adult foster individuals were placed with the family by a private agency rather than by the State or an agency of the State, the foster individuals were not "qualified foster individuals" within the meaning of Section 131. The court reached this conclusion even though the organization that placed the adults in the family's home both contracted with and received funds from the State of Oregon. Equal treatment of all foster care families (i) who receive payments from an agency that operates under a license or certification by a government entity or (ii) who receive payments directly from a government entity would reduce the confusion that currently exists. Foster families, like the family involved in the Micorescu case, would know with certainty whether they could exclude their income.

Taxpayers are not alone in their confusion. Section 131 has proven so confusing, in fact, that IRS officials and experienced certified public accountants and tax attorneys also have difficulty ascertaining when a payment is excludable. Our members can site various examples of situations in which foster care providers have been told informally by an IRS official and/or an experienced tax advisor that their foster care payments were to be excluded from taxable income, when in fact those payments were not excludable. Amending Section 131 would, therefore, prevent not only the confusion taxpayers and their tax advisors have over whether foster care payments are excludable, but also the confusion experienced by the IRS officials that are charged with administering the law.

C. Current treatment of foster care payments discourages much-needed foster care families from participating in foster care programs.—Current law discourages families from becoming foster care providers, even though these rules allow families to offset taxable foster care payments (paid by non-qualified agencies) by treating expenditures made on behalf of a foster individual as a business expense deductions. Such deductions are permitted only if the families maintain detailed expense records. Accordingly, otherwise willing foster care families are discouraged from accepting individuals placed by non-qualified agencies because such providers are forced to endure the time and inconvenience associated with keeping extensive records. In addition, the confusion created by Section 131's complex rules discourages many potential foster care families from participating in these programs. The result is a smaller pool of available, qualified and willing foster care providers and a growing pool of special needs individuals for whom group housing or institutional living is inappropriate. Amending Section 131 as suggested would help address the increasing demand for foster care providers.

D. Legislation introduced this year would remedy these problems.—Bills were introduced in the Senate (S.670) and in the House (H.R. 1194) that propose to eliminate the illogical differences in the tax treatment of payments received by foster care providers. These bills would simplify the current rules under Section 131 for foster care payments. Under the legislation, foster care providers would avoid onerous record keeping by excluding from income any foster care payment received regardless of the age of the foster care individual and the type of entity that placed the individual, as long as foster care payments are funded by governmental monies and the placement agency licensed or certified by a State or local government to make payments.

Conclusion

The Administration's proposal clarifies when a taxpayer, who is caring for a foster individual, may take the EITC and thus reduces taxpayer confusion and unintentional mistakes. The Administration's proposal is but one needed step, however, toward removing confusion created by the complicated rubric associated with the taxation of foster care payments. Therefore, we additionally recommend amending Section 131 of the Internal Revenue Code so that all governmental payments received by foster care providers be treated the same. This change should also be reflected in any change affecting the definition of "foster child" in Section 32. If enacted, current law's confusing and unfair tax rules would no longer discourage much-needed foster care families from participating in foster care programs. Amending Section 131 and Section 32 in this fashion also will support State and local governments in their efforts to reduce bureaucracy and cut costs, provide more alternatives to institutionalization and simplify tax administration.

February 23, 1999

The Honorable Bill Archer
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515–6348

The Honorable Charles Rangel
Ranking Member, Committee on Ways and Means
1106 Longworth House Office Building
Washington, D.C. 20515–6348

Dear Chairman Archer and Ranking Member Rangel:

We are writing to express our opposition to a provision in the Administration's FY 2000 budget proposal that would accelerate, from quarterly to monthly, the collection of most federal and state unemployment insurance (UI) taxes beginning in 2005. A similar proposal was put forth in the Administration's FY 1999 Budget and was rejected by Congress.

Imposing monthly collection of federal and state UI taxes is a burdensome device that accelerates the collection of these taxes to generate a *one time* artificial revenue increase for budget-scoring purposes and real, *every year* increases in both compliance costs for employers and collection costs for state unemployment insurance administrators. The Administration's proposal is fundamentally inconsistent with every reform proposal that seeks to streamline the operation of the UI system and with its own initiatives to reduce paperwork and regulatory burdens.

This proposal is even more objectionable than some other tax speed-up gimmicks considered in the past. For example, a proposal to move an excise tax deposit date forward by one month into an earlier fiscal year may make little policy sense, but it would not necessarily create major additional administrative burdens. The UI speed-up proposal, however, would result directly *in significant and continuing costs to taxpayers and to state governments*—tripling the number of required UI tax collection filings from 8 to 24 per affected employer each year.

The Administration implicitly recognizes that the added federal and state deposit requirements would be burdensome, at least for small business, since the proposal includes an exemption for certain employers with limited FUTA liability. Even many smaller businesses that add or replace employees or hire seasonal workers would not qualify for the exemption, however, since new FUTA liability accrues with each new hire, including replacement employees. This deposit acceleration rule makes no sense for businesses large or small, and an exemption for certain small businesses does nothing to improve this fundamentally flawed concept.

We are all strongly supportive of UI reform that simplifies the system and reduces the burden on employers and the costs of administration to the federal and state governments. Adopting the Administration's UI collection speed-up proposal, however, would take the system in exactly the opposite direction, creating even greater burdens than those which exist under the current system.

We urge you to reject the Administration's UI collection speed-up proposal and focus instead on proposals that would make meaningful system-wide reforms. Thank you for your consideration of our views on this important issue. Please do not hesitate to let us know if we can provide additional assistance.

Sincerely,

AMERICAN PAYROLL ASSOCIATION
AMERICAN SOCIETY FOR PAYROLL MANAGEMENT
AMERICAN TRUCKING ASSOCIATION
NATIONAL ASSOCIATION OF MANUFACTURERS
NATIONAL FEDERATION OF INDEPENDENT BUSINESS
NATIONAL RETAIL FEDERATION
SERVICE BUREAU CONSORTIUM, INC.
SOCIETY FOR HUMAN RESOURCE MANAGEMENT
U.S. CHAMBER OF COMMERCE
UWC, INC.

cc: Members of the Committee on Ways and Means

Statement of American Petroleum Institute

Introduction

This testimony is submitted by the American Petroleum Institute (API) for the March 10, 1999 Ways and Means hearing on the tax provisions in the Administration's fy 2000 budget proposal. API represents approximately 400 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing.

The U.S. oil and gas industry is suffering through its worst times in recent memory. The collapse of world oil prices that began in late 1997 continued and worsened through 1998. While there has been some modest recovery in prices in recent weeks, many analysts view this recovery as transitory, and see little firm basis for sustained recovery in market conditions for several years. It is especially troubling that at this time when the industry is already reeling, the Administration has come forward with proposals that would increase taxes on oil and gas companies by as much as $6 billion over the next five years. Congress can help to ensure that no additional harm is done to this industry by rejecting the Administration's proposal to increase taxes on the foreign source income of oil and gas companies, and the proposals to reinstate the Superfund taxes and the Oil Spill tax.

Background

By the end of 1998, as a result of reduced worldwide demand and excess production, U.S. wellhead crude oil prices had fallen to their lowest inflation-adjusted levels since the Great Depression. At year's end the average U.S. wellhead price was less than $8 per barrel, barely half the $15.06 average for the same month one year earlier. For the year, the annual average wellhead price was an estimated $10.85 per barrel, down by more than a third from $17.24 in 1997.

Domestic oil exploration and development activity suffered dramatically from the lower oil prices. The total number of operating rigs in the U.S. fell 44% from February 98 to February 99. The decline for oil rigs was 69% and for gas rigs 28%. Oil and gas companies' current upstream spending plans for 1999 for the U.S. have been cut by 20 percent, according to a recent survey conducted by Salomon Smith Barney. U.S. companies have been forced to delay or outright cancel projects in other regions of the world, as well.

Industry employment has suffered. Bureau of Labor Statistics data show that from October 1998 to February 1999 the oil and gas extraction industry, including field service companies, lost 26,000 jobs. That 4 month loss was 6,000 more jobs than were lost during the entire year from October 1997 to October 1998. The most recent decline reduced the number of upstream jobs in the U.S. to about 291,000—60 percent less than the peak in early 1982 of 754,000 jobs.

For petroleum refiners lower crude oil prices generally have not yielded higher refinery profit rates. Gasoline prices for 1998, adjusted for inflation, were the lowest observed since 1920. Regular gasoline prices dropped to 96 cents per gallon by year-end. They averaged about $1.06 per gallon for the year. The low product prices have come on the heels of major operating cost increases resulting from compliance with numerous government regulations, especially regulations aimed at environmental improvement. In 1997 (the latest year available), the refining sector spent slightly over $4 billion on U.S. environmental expenditures.

Administration Proposals

Our testimony will address the following proposals:

- modify rules relating to foreign oil and gas extraction income;
- reinstate excise taxes and the corporate environmental tax deposited in the Hazardous Substance Superfund Trust Fund;
- reinstate the oil spill excise tax;
- corporate tax shelters;
- Harbor Maintenance Tax Converted to User Fee; and
- tax investment income of trade associations

RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

President Clinton's budget proposal includes the following provisions:

- In situations where taxpayers are subject to a foreign income tax and also receive an economic benefit from the foreign country, taxpayers would be able to claim a credit for such taxes under Code Section 901 only if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under the generally applicable income tax.

• Effective for taxable years beginning after enactment, new rules would be provided for all foreign oil and gas income (FOGI). FOGI would be trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI).

• Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations.)

This proposal, aimed directly at the foreign operations of U.S. petroleum companies, seriously threatens the ability of those companies to remain competitive on a global scale, and API strongly opposes the proposal.

If U.S. oil and gas concerns are to stay in business, they must look overseas to replace their diminishing reserves, since the opportunity for domestic reserve replacement has been restricted by both federal and state government policy. The opening of Russia to foreign capital, the competition for investment by the countries bordering the Caspian Sea, the privatization of energy in portions of Latin America, Asia, and Africa—all offer the potential for unprecedented opportunity in meeting the challenges of supplying fuel to a rapidly growing world economy. In each of these frontiers U.S. companies are poised to participate actively. However, if U.S. companies can not economically compete, foreign resources will instead be produced by foreign competitors, with little or no benefit to the U.S. economy, U.S. companies, or American workers.

With non-OPEC development being cut back, and OPEC market share once again rising, a key concern of federal policy should be that of maintaining the global supply diversity that has been the keystone of improved energy security for the past two decades. The principal tool for promotion of that diversity is active participation by U.S. firms in the development of these new frontiers. At a time when those operations are especially vulnerable, federal policy should be geared to enhancing the competitiveness of U.S. firms operating abroad, not reducing it with new tax burdens.

The foreign tax credit (FTC) principle of avoiding double taxation represents the foundation of U.S. taxation of foreign source income. The Administration's budget proposal would destroy this foundation on a selective basis for foreign oil and gas income only, in direct conflict with long established tax policy and with U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

The FTC Is Intended To Prevent Double Taxation

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC is intended to prevent the same income from being taxed twice, once by the U.S. and once by the source country. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions. Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (except for certain "passive" or "Subpart F" income.) Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10% of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

Basic Rules of the FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by multiplying the tentative U.S. tax on worldwide income by the ratio of foreign source income to worldwide taxable income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for not less than 9 "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category. Thus, for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be easily changed; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

FTC Limitations For Oil And Gas Income

Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by OPEC, taxes on foreign oil and gas income have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35% (the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in extraction activities.

In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI nor FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

The Dual Capacity Taxpayer "Safe Harbor" Rule

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly or through a state owned enterprise (e.g., a license or a production sharing contract). Because the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department in 1983 finalized the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment and is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, is considered a royalty). The regulations also include a safe harbor election (see Treas. Reg. 1.901–2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

The Proposal Disallows FTCs Of Dual Capacity Taxpayers where the Host Country Has No Generally Applicable Income Tax

If a host country had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, the proposal would disallow any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; it could also change the economics of past investments. In some cases, this would not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it would also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The unfairness of the provision becomes even more obvious if one considers the situation where a U.S. based oil company and a U.S. based company other than an oil company are subject to an income tax in a country without a generally applicable income tax. Under the proposal, only the U.S. oil company would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not be denied complete creditability against U.S. income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, rather than being dependent on the foreign sovereign's fiscal choices.

The Proposal Limits FTCs To The Amount Which Would Be Paid Under the Generally Applicable Income Tax

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its income tax payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies of lesser developed countries which may not be ready for an income tax, as for post-industrial nations which may turn to a transaction tax, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available tax regimes are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

The Proposal Increases The Risk Of Double Taxation

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85% tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Country X has no generally applicable income tax. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

Because of the 35% additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50% greater than the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

Separate Limitation Category For FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general limitation category or basket. There is no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGEI and FORI is difficult to manipulate. The source of FOGI was determined by nature millions of years ago. FORI is generally derived from the country where the processing or marketing of oil occurs which presupposes substantial investment in nonmovable assets. Moreover, Treasury has issued detailed regulations addressing this sourcing issue. Also, unless any FORI is earned in the extraction or consumption country, it is very likely taxed currently, before distribution, as subpart F income even though it is definitely not passive income.

The FTC Proposals Are Bad Tax Policy

Reduction of U.S. participation in foreign oil and gas development because of misguided tax provisions will adversely affect U.S. employment, and any additional tax burden may hinder U.S. companies in competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies increases utilization of U.S. supplies of hardware and technology. The loss of any major foreign project by a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations. Many of the jobs that support overseas operations of U.S. companies are located here in the United States—an estimated 350,000 according to a 1998 analysis by Charles River Associates, a Cambridge, Massachusetts-based consulting firm. That figure consists of: 60,000 in jobs directly dependent on international operations of U.S. oil and gas companies; over 140,000 employed by U.S. suppliers to the oil and gas industry's foreign operations; and, an additional 150,000 employed in the U.S. supporting the 200,000 who work directly for the oil companies and their suppliers.

Thus, the questions to be answered are: Does the United States—for energy security and international trade reasons, among others—want a U.S. based petroleum industry to be competitive in the global quest for oil and gas reserves? If the answer is "yes," then why would the U.S. government adopt a tax policy that is punitive in nature and lessens the competitiveness of the U.S. petroleum industry? The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil and gas business environment. These improvements should include, among others, the repeal of the plethora of separate FTC baskets, the extension of the carryback/carryover period for foreign tax credits, and the repeal of section 907.

The Administration's fy 1999 budget included these same proposals which would have reduced the efficacy of the FTC for U.S. oil companies. Congress considered these proposals last year and rightfully rejected them. They should be rejected this year as well.

REINSTATMENT OF EXPIRED SUPERFUND TAXES

The Administration's proposal would reinstate the Superfund excise taxes on petroleum and certain chemicals as well as the Corporate Environmental Tax through October 1, 2009. API strongly opposes this proposal.

It is generally agreed that the CERCLA program, otherwise known as Superfund, has matured to the point that most of the sites on the National Priorities List (NPL) are in some phase of cleanup. Problems, however, remain in the structure of the current program. The program should undergo comprehensive legislative reform and should sunset at the completion of cleanups of the CERCLA sites currently on the NPL. Issues that the reform legislation should address include: liability, remedy selection, and natural resource damage assessments. A restructured and improved Superfund program can and should be funded through general revenues.

Superfund sites are a broad societal problem. Revenues raised to remediate these sites should be broadly based rather than unfairly burdening a few specific industries. EPA has found wastes from all types of businesses and government agencies at hazardous waste sites. The entire economy benefited in the pre–1980 era from the lower cost of handling waste attributable to standards that were acceptable at the time. To place responsibility for the additional costs resulting from retroactive Superfund cleanup standards on the shoulders of a very few industries when previous economic benefits were widely shared is patently unfair.

The petroleum industry is estimated to be responsible for less than 10 percent of the contamination at Superfund sites but has historically paid over 50 percent of the Superfund taxes. This inequity should be rectified. Congress should substantially reform the program and fund the program through general revenues or other broad-based funding sources.

REINSTATMENT OF OIL SPILL EXCISE TAX

The Administration proposes reinstating the five cents per barrel excise tax on domestic and imported crude oil dedicated to the Oil Spill Liability Trust Fund through October 1, 2009, and increasing the trust fund limitation (the "cap") from $1 billion to $5 billion. API strongly opposes the proposal.

Collection of the Oil Spill Excise Tax was suspended for several months during 1994 because the Fund had exceeded its cap of $1 billion. It was subsequently allowed to expire December 31, 1994, because Congress perceived there was no need for additional taxes. Since that time, the balance in the Fund has remained above $1 billion, despite the fact that no additional tax has been collected. Clearly, the legislated purposes for the Fund are being accomplished without any need for additional revenues. Congress should reject this proposal.

CORPORATE TAX SHELTERS

In a sweeping attack on corporate tax planning, the Administration has proposed sixteen provisions purported to deal with corporate tax shelters. These proposals are overly broad and would bring within their scope many corporate transactions that are clearly permitted under existing law. Moreover, their ambiguity would leave taxpayers uncertain as to the tax consequences of their activities and would lead to increased controversy and litigation. Business taxpayers must be able to rely on the tax code and existing income tax regulations in order to carry on their business activities. Treasury's proposed rules could cost the economy more in lost business activity than they produce in taxing previously "sheltered" income.

HARBOR MAINTENANCE EXCISE TAX CONVERTED TO COST-BASED USER FEE

The Administration's budget contains a placeholder for revenue from a new Harbor Services User Fee and Harbor Services Fund. This fee would raise nearly $1 billion in new taxes, almost twice what is needed for maintenance dredging. The Administration delayed sending the proposal to the 105th Congress because of the intense and uniform opposition from ports, shippers, carriers and labor. Despite this opposition, the Administration has provided few details about how the new user fee would be structured and has not sought stakeholder input since last September.

API strongly supports the use of such funds for channel maintenance and dredge disposal. We object to the Administration's proposal to use these funds for port construction and other services. The Administration should earmark these funds to address the growing demand for harbor maintenance and dredging. Moreover, we urge Congress to pass H.R. 111 and create an off-budget trust fund for the Harbor Services Fund. Finally, API urges Congress to take the lead in seeking stakeholder input and developing a fair and equitable means of generating the needed revenue.

SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

The Administration's proposal would subject to tax the net investment income in excess of $10,000 of trade associations and other organizations described in section 501(c)(6). API opposes this provision that is estimated to increase taxes on trade associations and other similar not-for-profit organizations by $1.4 billion. We agree with the Tax Council and other groups that subjecting trade association investment income to the unrelated business income tax (UBIT) conflicts with the current-law purpose of imposing UBIT on associations and other tax-exempt organizations to prevent such organizations from competing unfairly against for-profit businesses. The Administration's proposal mischaracterizes the benefit that trade association members receive from such earnings. Without such earnings, members of these associations would have to pay larger tax-deductible dues. There is no tax abuse. Congress should reject this proposal.

Statement of the American Public Power Association

The American Public Power Association (APPA) is pleased to present this statement on the electric restructuring tax proposal included in the president's FY 2000 budget. APPA is the national service organization representing the interests of more than 2,000 municipal and other state and locally owned utilities throughout the United States. Collectively, public power utilities deliver electric energy to one of every seven U.S. electric consumers (about 40 million people), serving some of the nation's largest cities. However, the majority of APPA's member systems are located in small and medium-sized communities in every state except Hawaii.

APPA appreciates the opportunity to comment on the Administration's proposal on tax-exempt bonds for electric facilities of public power entities. The proposal deals with an issue of extreme importance to the more than 2,000 community-owned electric providers, the bondholders of the over $75 billion in outstanding tax-exempt bonds and the communities that rely on low cost, reliable electric power. This is an issue that has developed as a result of wholesale and retail electricity competition, and needs legislative attention as soon as possible.

CHANGING CIRCUMSTANCES:

Many states have begun to establish retail electricity markets, abolishing the traditional regulated monopoly regime and replacing it with one in which all consumers have a choice of electricity suppliers. Nearly twenty states have adopted such legislation or regulation to open up to competition. These state laws can not be effective unless Congress removes certain tax barriers to retail competition. One such barrier is the existing "private use" test on the over $75 billion in outstanding tax-exempt bonds used to build and maintain electric generation, transmission and distribution facilities. In addition, consumers need desperately for Congress to clarify existing tax law to encourage an efficient and fair electric marketplace.

This state trend to promote retail electric competition follows action by Congress in 1992 to increase competition at the wholesale level, by empowering the Federal Energy Regulatory Commission (FERC) to compel all transmission owners, including public power systems, to allow third parties equaitable access to their transmission lines. If municipal electric utilities open their transmission systems to wholesale competition, they face violating the private use restrictions on their existing tax-exempt bonds, thus creating an enormous disincentive for public power systems to embrace both retail and wholesale electricity competition.

Municipal electric utilities that have issued tax-exempt bonds to finance their facilities under the old regulated monopoly framework face tough and potentially costly options for operating in the new restructured legal environment. If municipal utilities enter the competitive arena and violate the private use restrictions, tax-exempt bond financing on their affected facilities utilized by private parties becomes retroactively taxable, leading to immediate bondholder lawsuits. Or, in the alternative, municipal utilities may decide to compete and refinance their facilities with taxable bonds, causing an increase in financing costs. In either case, existing customers will have to pay higher electricity prices due to the accommodation to regulatory changes that no one foresaw at the time of the original financings. On the other hand, if public power systems choose not to compete, they will inevitably lose customers, resulting in the remaining customers paying higher costs for the underutilized infrastructure.

ADMINISTRATION'S PROPOSAL—A STEP IN THE RIGHT DIRECTION

We commend the Administration's legislative proposal to eliminate federal tax code barriers to electricity competition facing public power. Most importantly, the Administration's tax proposal lifts the existing private use test on outstanding tax-exempt bonds and eliminates a disincentive for public power systems to participate in wholesale and retail electricity competition. In addition, this provision also protects existing bondholders from the possible retroactive taxability of their bonds. Lastly, the Administration's bill preserves public power systems' ability to issue tax-free bonds for local distribution facilities, which is defined as 69kv or lower.

Unfortunately, the proposal is in effect, a federal mandate that prohibits all community owned utilities from building or maintaining transmission and generation facilities, on a tax-exempt basis. Most small municipalities do not have outstanding tax-exempt bonds and would therefore endure a significant penalty to resolve a problem that does not currently apply to them. Moreover, this prohibition applies even if the transmission or generation facilities are dedicated to municipal functions providing public benefits to its community. APPA believes this aspect of the Administration's proposal is extremely severe, hindering many smaller community owned electric systems from utilizing tax-exempt debt for important infrastructure needs, and exercising their rights of local control. With regard to transmission, energy policy is moving us to a system in which all consumers will benefit if building certain portions of the transmission gird is done on a tax-exempt basis, thus lowering costs for all consumers.

In summary, the Administration's tax proposal moves us in the right direction, in that it protects the existing tax-exempt debt of public power communities, but on a prospective going forward basis it is unnecessarily severe for many communities that have no outstanding bonds and would prefer to preserve their existing authority over financing of electric generation and transmission facilities.

APPA is pleased that the Administration is sensitive to these concerns and would like to work together with members of Congress and public power communities to address this concern. In fact, on February 4th, Energy Secretary Bill Richardson wrote to APPA and acknowledged some differences in their approach and said he believed "these differences can be resolved. It is absolutely essential that Congress address this issue quickly so as not to further impede the progress of competitive programs," Secretary Richardson said. (See attached DOE letter dated February 4, 1999.)

A FAIR, BIPARTISAN COMPROMISE IS ADVANCED—The Bond Fairness and Protection Act of 1999, H.R. 721/S. 386

A proposal that embraces local control and local choices has been advanced in Congress. The Bond Fairness and Protection Act of 1999 is much better suited to deal with the diversity in the marketplace, while protecting the fundamental rights of state and local government, and providing transition relief to the outstanding tax-exempt bonds.

More specifically, the Bond Fairness and Protection Act, a bill introduced in the Senate as S. 386 by Senators Slade Gorton (R–WA) and Robert Kerrey (D–NE) and in the House as H.R. 721 by Representatives J.D. Hayworth (R–AZ) and Robert Matsui (D–CA), is a compromise solution to the private use problem. If enacted, the Gorton-Kerrey/Hayworth-Matsui bill will accomplish two objectives: 1) clarify existing tax laws and regulations regarding the private use rules so that they will work in a new competitive marketplace; and 2) provide encouragement for public power utilities to open their transmission or distribution systems, thereby providing more choice to all consumers.

Under the bill, publicly owned utilities would have two options: 1) They could continue to operate under a clarified version of the existing tax laws and private use regulations; or 2) If relief from private use restrictions were needed, municipal utilities could opt for a full grandfathering of their outstanding tax-exempt debt, but they would have to exercise an "irrevocable termination election," *permanently eliminating their ability to issue tax-exempt debt to build any new generating facilities.* Such an election would not affect transmission and distribution facilities which unlike generation will continue to operate as regulated monopolies. This removes the disincentive for municipal electric systems to participate in competitive markets without providing a competitive advantage to either public power or private utilities.

Because the bill provides publicly owned utilities the flexibility to participate in competitive markets without jeopardizing the tax-exempt status of their bonds while requiring a significant trade-off to some private utilities' concerns, it has attracted the support of a number of organizations. The list includes: The National League of Cities, The National Association of Counties, The Governors Public Power Alliance, The International City/County Managers Association, The Government Finance Officers Association, The California Independent Energy Producers, Enron, the National Consumers' League, Public Citizen, and The Natural Resources Defense Council and some individual investor-owned utilities. A number of investor owned utilities either support or are neutral on the bill, and many are seeking small clarifications to help promote competition in general.

CONCLUSION:

A fully competitive retail electricity market will include a variety of electrical suppliers, many of which are for-profit, taxable entities and others like public power systems, that are not-for profit state and local agencies. Each type of market participant faces barriers to participate in future competitive markets. Municipal financing concerns are one barrier that must be addressed as part of a balanced approach to a fair and open marketplace. The Administration's tax provision is a step in the right direction, but, Congress should embrace efforts to preserve local communities' choices and instead enact H.R 721/S. 386, a bipartisan compromise that makes political and economic sense.

We appreciate the opportunity to present our statement, and look forward to working with the Ways and Means members and staff as the budget debate progresses.

[Attachment is being retained in the Committee files.]

ASSOCIATED BUILDERS AND CONTRACTORS, INC.
ROSSLYN, VIRGINIA 22209
March 24, 1999

The Honorable Bill Archer
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of Associated Builders and Contractors (ABC) and its more than 20,000 member firms, I would like to respectfully submit the following comments for the record of the hearing of March 10, 1999 entitled "Revenue Provisions in President's Fiscal Year 2000 Budget."

President Clinton's FY 2000 budget proposes a significant tax increase on Associations that are tax exempt under section 501 (c) (6) of the Internal Revenue Code. Under the administration's proposal, trade associations that have net "investment" income in excess of $10,000 for any taxable year would be subject to the unrelated business income tax (UBIT), for the portion over $10,000. This would adversely affect ABC's tax liability, as well as the tax liability of our chapters that may have "investment" income over $10,000. ABC strongly opposes this proposal, which would significantly impact ABC's financial status.

ABC's "investment" income is not generated by any activity in competition with tax-paying businesses. Congress recognized in the "unrelated business tax" (UBIT) rules, that Section 501 (c)(6) tax-exempt groups were not competing with for-profit entities or being unfairly advantaged by the receipt of tax-exempt income from certain "passive" sources such as interest, dividends, capital gains and royalties. ABC and other associations' income from these sources are used to further its exempt purposes, including education, improving industry safety, and training, and for community involvement. For example, ABC might be forced to curtail its ongoing non-profit efforts to attract and train young people for a lucrative career in the construction industry.

Additionally, it is important to recognize that keeping this "investment" and "passive" income free from taxation enables ABC and other 501 (c)(6) associations to maintain modest surplus funds from year to year in order maintain stability during economic downturns.

The Administration's proposal appears to assume that 501 (c)(6) associations like ABC are effectively over-charging their members for dues, and their members expect to realize investment gains from those overpayments. This is absurd logic, which shows a patent misunderstanding of the structure and operation of tax-exempt organizations. In fact, dues payments do not make up the larger portion of an average association's annual revenue.

For the aforementioned reasons, ABC would like to express its strong opposition to the Administration's proposal to tax 501 (c)(6) investment income. Thank you for considering ABC's comments.

Sincerely,

CHRISTOPHER T. SALP
Washington Representative

ASSOCIATION FOR PLAY THERAPY
FRESNO, CA 93703
March 9, 1999

Hon. Bill Archer, Chair
Committee on Ways and Means
United States House of Representatives
1102 Longworth Office Building
Washington, DC 20515

Re: Opposition to Taxing Association Savings

Dear Chair Archer:

During its February 27 meeting in Baltimore, MD, the Board of Directors of the International Association for Play Therapy, Inc. unanimously elected to oppose the Administration budget proposal to raise $1.4 billion over the next five years by taxing interest and dividends in excess of $10,000 earned annually by non-profit organizations.

Our private 501c(6) association and its 3,300 volunteer member mental health professionals have since 1982 researched and promoted the therapeutic benefits of play and play therapy on behalf of children and others. We have diligently and responsibly built an emergency reserve fund, the earnings from which may eventually finance research and other programs that further satisfy our mission statement. Because competition for grants, sponsorships, and other forms of non-dues revenues is fierce, it is critical that we and other associations continue to enjoy this fundraising option and that interest earned from our savings not be taxed.

Please advise me if you will oppose this proposal. Your leadership and assistance are critical and sincerely appreciated. Thank you very much.

Cordially,

WILLIAM M. BURNS
Executive Director

cc: Chair Rise VanFleet, Ph.D.

Statement of Association of International Automobile Manufacturers, Inc., Arlington, Virginia

The Association of International Automobile Manufacturers, Inc. ("AIAM") respectfully submits this statement for the Committee on Ways & Means March 10, 1999 hearing record regarding the Revenue Provisions in the President's Budget for Fiscal Year 2000. AIAM is a trade association that represents companies which sell passenger cars and light trucks in the United States that are manufactured both here and abroad.[1]

AIAM members import and produce in U.S. manufacturing facilities light vehicles for sale in the U.S. Automobile manufacturers have invested millions of dollars into the research and development of environmentally superior vehicles, yet the demand for these autos remain at remarkably low levels. Nearly every automaker in the world has begun development of advanced propulsion technology vehicles. For example, motor vehicles like Honda's EV Plus, Nissan's Altra, and Toyota's Prius are currently offered (or will be shortly) for sale in the U.S. market by these innovative automobile manufacturers.

While AIAM reserves judgement on the details of the Administration's Fiscal Year 2000 Budget proposal to provide a tax credit for advanced technology vehicles, AIAM endorses the underlying market-based principles of the proposal. Should the

[1] AIAM is the trade association representing the U.S. subsidiaries of international automobile companies doing business in the United States. Member companies distribute passenger cars, light trucks, and multipurpose passenger vehicles in the U.S. Nearly two-thirds of these vehicles are manufactured in the New American Plants established by AIAM companies in the past decade.

International automakers support American jobs in manufacturing, supplier industries, ports, distribution centers, headquarters, R & D centers and automobile dealerships. AIAM also represents manufacturers of tires and other original equipment with production facilities in the U.S. and abroad.

Committee desire any assistance in the development of this tax incentive, AIAM stands ready to be involved in the process.

While automakers continue to make strides in environmental technology, there is a lack of consumer demand for new premium priced advanced technology vehicles. Creating market-driven incentives to entice consumers towards the purchase of environmentally superior vehicles is necessary if we are going to achieve the environmental gains we all desire. AIAM believes credits will *encourage* the purchase of new environmentally superior vehicles.

There currently are two design principles that AIAM member companies agree should be included in a tax incentive program. Incentives should capitalize on the power and efficiency of the retail market; and should be easy for consumers to use.

INCENTIVES SHOULD CAPITALIZE ON THE POWER AND EFFICIENCY OF THE RETAIL MARKET

The retail vehicle market is a ready institution for bringing incentives directly to bear on the people who may want to buy fuel efficient vehicles at the moment they are making that choice. The market, being a constant factor in purchasing decisions, will deliver economic incentives and results with virtually no delay or administrative cost.

An unsatisfactory alternative to a market-driven design would be a new command-and-control regime of regulations between manufacturers and government. By all experience, the erection and operation of another regulatory apparatus would be slow, expensive, nonadaptive, and adversarial. It could not be structured in any way to deal with potential buyers as they decide whether to choose fuel-efficient vehicles.

It is AIAM's opinion that a market-based approach to energy conservation is superior in effectiveness to regulation. Market incentives encourage energy conservation and the costs on society is far less than those imposed by command-and-control regulations.

INCENTIVES SHOULD BE EASY FOR CONSUMERS TO USE

For this type of policy to succeed through tax incentives, the incentives should be easy for consumers to use.

To be most effective in selling fuel-efficient vehicles, the availability and value of the credit should be certain and palpable at the buyer's moment of decision.

To achieve the program's objectives, the credit should be available whether the potential buyer is an individual or business; rich, poor, or middle-income; is a minimum tax payer or not; is considering a foreign-or domestic-manufactured vehicle, and other distinguishing characteristics.

AIAM believes that a manufacturers' rebate-style incentive at point of purchase is the most effective type of credit. This type of approach would provide an immediate and enticing incentive for the purchase of an advanced technology vehicle. This could be accomplished by designing the credit so that it goes directly to the manufacturer. The manufacturer, in turn, would pass the incentive along to the customer at the time of purchase, thereby creating an immediate incentive to purchase the qualifying vehicle.

CONCLUSION

The Administration has taken a constructive step by promulgating the concepts of tax incentive programs for the purchase of qualifying fuel efficient vehicles. Building a basis for market-driven consumer incentive policy is important in creating a demand for advanced technology vehicles in the United States that have the potential to deliver environmental and energy-saving benefits. AIAM would be pleased to provide the Committee whatever further information on this issue the Committee would find useful.

Statement of Bond Market Association

The Bond Market Association is pleased to present this statement on tax proposals in the president's FY 2000 budget. The Bond Market Association represents approximately 200 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. We take an active interest in tax policy that affects the ability of corporations, state and local governments and the federal government to access the capital markets to finance investment. Indeed, capital investment is the engine that powers long-term economic growth, and the federal tax code can have a profound effect on the cost of capital investment. It is in our interest and, we believe, the nation's interest to foster a tax system that encourages capital investment and makes capital available as efficiently as possible.

Perhaps the most important thing Congress has done in recent years to facilitate capital investment has been to pursue policies which helped to eliminate the federal budget deficit. For decades, the deficit served as a drain on the pool of funds available to finance new investment. Every dollar of overspending was a dollar not available to build roads, schools, factories, housing and other capital assets that contribute to economic growth and improve living standards. This committee, under Chairman Archer's leadership, played a vital role in crafting policies that have eliminated the deficit and freed up economic resources for productive use. At the same time, this committee has managed to resist ill-conceived tax increases on capital formation and has even supported proposals designed to expand access to the capital markets, such as last year's increase in tax-exempt private-activity bond volume caps. For that, we commend you.

The president's budget contains a number of proposals that would affect the capital markets. Unfortunately, many of these proposals are recycled versions of the same tax increases that Congress has rejected for years. As we have in the past, we strongly oppose these tax increases on savings and investment. Other proposals, although well-intentioned, would likely not provide the level of assistance they are intended to.

Tax Increase Proposals

Increase proration percentage for property and casualty companies

The Association commented extensively on a variation of this proposal in our statement to the committee in February 1998.[1] Although the administration has tempered the proposal slightly in its current budget, it would still represent a significant tax increase on "tax-exempt" interest earned by property and casualty (P&C) insurance companies.

P&Cs are an extremely important source of demand for municipal securities. In a market dominated by individual investors—approximately 64 percent of outstanding municipal bonds are held by individuals or their proxies, money-market and mutual funds—P&Cs play a vital role in maintaining market stability by providing a steady source of demand. If not for the active participation of P&Cs in the municipal bond market, state and local borrowing rates would be much higher than they are.

So-called "tax-exempt" interest earned by P&Cs on municipal bond transactions is not truly tax-exempt. P&Cs are permitted a deduction for contributions to loss reserves. However, this deduction is reduced by an amount equal to 15 percent of their "proration income," which includes tax-exempt bond interest. P&Cs lose 15 cents of an otherwise allowable deduction for every dollar of tax-exempt interest they earn. This loss of deduction is tantamount to a direct tax of 5.25 percent on their municipal bond interest income.

The administration has proposed raising the loss reserve deduction disallowance from 15 percent of proration income to 25 percent. This would increase the implicit tax rate on municipal bond interest earned by P&Cs from 5.25 percent to 8.75 percent, an increase of 67 percent. (In its FY 1999 budget, the administration proposed a full doubling of the proration tax.) Describing the administration's proposal as a tax increase on P&Cs, however, disguises its true effect. In reality, the burden of this proposed tax increase would fall almost entirely on state and local government bond issuers, not on P&Cs. Under current market conditions, interest rates on tax-exempt securities would not be sufficient to continue to attract P&Cs to the municipal market. Unfortunately, in the market sectors where P&Cs are most active, there are few other ready buyers at current interest rates. It is likely that if the administration's proposal were enacted, once municipal bond yields rose to fully reflect the proposal's effects, P&Cs would remain active as municipal market investors. However, interest rates paid by state and local governments on their borrowing would be higher than if the proposal had not been enacted. P&Cs will simply be compensated for their additional tax liability through higher returns on their municipal bond portfolios. The effect for state and local governments would be higher borrowing costs. Implicitly, approximately 40–60 percent—perhaps up to 75 percent—of the tax would be borne not by P&Cs but by state and local governments in the form of higher borrowing costs. Of course, higher borrowing costs simply discourage new investment in schools, roads, airports, sewer systems, parks and the many other in-

[1] Statement of The Bond Market Association, Submitted to the House Committee on Ways and Means, on Certain Revenue Provisions in the Administration's FY 1999 Budget, February 25, 1998.

frastructure projects that are financed with tax-exempt bonds. The staff of the Joint Committee on taxation was absolutely correct in its analysis:

> [P&C] insurers are large holders of tax-exempt bonds. A reduction in demand for these securities by the [P&C] insurers may lead to an increase in borrowing costs for state and local governments. Even a small increase in the interest cost to tax-exempt finance could create a substantial increase in the aggregate financial cost of debt-financed public works projects to state and local governments.[2]

Moreover, the administration has offered little justification for this proposed tax increase. The Treasury Department states only that a 5.25 percent P&C tax on municipal bond interest is too low because it "still allows [P&Cs] to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income."[3] This argument fails to draw any parallel between interest earned on municipal bonds and deductions for contributions to loss reserves. The relationship between municipal bond interest and loss reserve deductions is no closer than that between municipal bond interest and any deductible expense, such as that for wages and salaries. The administration also fails to justify the apparent arbitrary proration percentage level contained in its proposal. Why is a 25-percent proration level more appropriate than a 15-percent level? Why in its FY 1999 budget did the administration propose a 30-percent level, but this year's proposal is for a 25-percent level? Both questions are unanswered, and both suggest that the administration's proposal is less an adjustment of tax policy to address changing circumstances and more a pure tax increase proposed solely as a revenue-raiser with little tax policy justification.

Disallow Interest on Debt Allocable to Tax-exempt Obligations

A second proposed tax increase in the administration's budget is also ostensibly targeted at corporations. However, like the "proration" issue discussed above, this tax increase would be borne by state and local government bond issuers who would pay higher interest rates on their borrowing. This proposal would apply the current-law "pro rata" interest expense disallowance that applies to financial institutions to all financial intermediaries.

Currently, all taxpayers, including all corporations, are prohibited from deducting interest expenses associated with purchasing or carrying tax-exempt bonds. Most corporations, including some financial intermediaries, are required to demonstrate that any tax-exempt bond holdings were not financed with the proceeds of borrowing—the so-called "tracing rule." Most corporations are relieved of this burden if their tax-exempt bond holdings do not exceed two percent of their total assets—the so-called "two-percent de minimis rule." Securities firms and banks, however, are subject to stricter treatment; they automatically lose a pro rata portion of their interest expense deduction if they earn any tax-exempt interest. In applying the disallowance, securities firms are permitted to disregard interest expense that is clearly traceable to activities unrelated to municipal bonds. The administration's proposal would apply the pro rata disallowance provision currently applicable to banks to all "financial intermediaries," including securities firms, finance and leasing companies, and certain government-sponsored corporations. The proposal would affect various segments of the municipal bond market differently.

For securities firms, the proposal would apply the current-law pro rata disallowance to a larger portion of a firm's total interest expense deduction, even to interest which is clearly and demonstrably unrelated to holding municipal bonds. A large portion of a securities firm's borrowing is for specific purposes. Securities firms use repurchase agreements—a form of secured borrowing—to finance overnight holdings of Treasury securities bought in the normal course of market-making activity. Or, in another example, firms incur margin loans for stock purchases. In both these examples, the interest expense associated with the borrowing is clearly related to activity unrelated to buying or holding municipal bonds, and so is disregarded in applying the pro rata disallowance of interest expense. In both these examples as well as others, under the administration's proposal, this interest expense would be subject to the disallowance. Securities firms' after-tax costs of carrying municipal bonds would increase.

Securities firms buy and sell municipal bonds in the normal course of doing business. As underwriters, they buy newly issued securities and resell them to investors. When investors seek to sell bonds before their maturity, securities firms quote

[2] Staff of the Joint Committee on Taxation, "Description of Revenue Provisions in the President's FY 2000 Budget Proposal" (JCS–1–99), February 22, 1999, pgs. 275–276.

[3] Department of the Treasury, "General Explanations of the Administration's Revenue Proposals, February 1999, page 159.

prices and buy municipal bonds on the secondary market. As a result of the administration's proposal, the after-tax cost of holding municipal bonds in the normal course of business would increase because every time a securities firm bought a bond, it would face a higher after-tax "cost of carry." Firms would be less willing, at least on the margin, to take positions in municipal securities being bought and sold by investors and would consequently bid prices less aggressively. In the end, virtually all the additional tax liability faced by securities firms would ultimately be borne by bond issuers and investors in the forms of higher issuance and transaction costs.

The administration's proposal would affect other market sectors, as well. The proposal would remove government-sponsored corporations from the markets for tax-exempt housing and student loan bonds by repealing the two-percent de minimis rule for these investors. Organizations such as Fannie Mae and Freddie Mac are major buyers of bonds issued for low-and middle-income owner-occupied and multi-family rental housing. Sallie Mae buys tax-exempt student loan bonds. These investors keep financing costs low for worthwhile state and local housing and student loan programs, and their loss from the market would make it more difficult and more expensive for states and localities to provide these services. Finally, the proposal would dramatically raise costs for firms that finance equipment leases for states and localities. These costs would be passed onto state and local governments in the form of higher leasing costs. Hardest hit would be smaller governments, since they have a more difficult time accessing the conventional capital markets and tend to depend more on leasing as a form of long-term financing.

The administration argues that current law permits securities dealers and other financial intermediaries "to reduce their tax liability inappropriately through double federal tax benefits of interest expense deduction and tax-exempt interest, notwithstanding that they operate similarly to banks." This statement is simply not true. Current law could not be more direct. It is not legal for any corporation to deduct the interest expense associated with holding tax-exempt bonds. It is true that not all corporations are bound to the pro rata disallowance of interest expense deductions as banks are. Equalizing treatment between banks and non-banks, however, could just as easily entail the application of the tracing and two-percent de minimis rules to banks as the application of the pro rata disallowance to non-banks. The administration also argues that "the treatment of banks should be applicable to other taxpayers engaged in the business of financial intermediation, such as securities dealers." And further, "it is difficult to trace funds within the institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings." Both these statements are very misleading. In fact, banks and securities firms are both subject to nearly identical rules under current law. Both are already subject to the pro rata disallowance of interest expense deductions. Securities firms are simply able, in applying the disallowance, to disregard certain interest expense that clearly is traceable. Moreover, of The Bond Market Association's numerous commercial bank members, we are aware of none that have complained about unfair treatment under current law or who have called for anything similar to the administration's proposal.

Require Current Accrual of Market Discount by Accrual Method Taxpayers

Under current law, market discount occurs when taxpayers buy bonds at a discount to face value (par). Market discount, the difference between a bond's purchase price and its face value, is generally treated as ordinary interest income. The only exception is that tax liability is incurred not annually, but when the bond is sold or redeemed. The administration has proposed that accrual taxpayers would be required to recognize the accrual of market discount—and pay taxes on that accrual—annually.

Much of the problem with the administration's proposed treatment of market discount stems from its mistreatment under current law. On the basis of good tax policy and for purposes of tax symmetry, market discount really should be treated as a capital gain rather than as ordinary income. After all, market discount occurs when, as a result of a decline in market prices, a bond is sold in the secondary market at a price lower than its original issue price (or, in the case of a bond with original issue discount, its adjusted issue price). In such a case, the seller of the bond would incur a capital loss. The buyer of the bond, however, would recognize ordinary income. Such treatment is, at the very least, unfair. This asymmetry is mitigated, however, by the fact that like a capital gain, taxpayers are not required to recognize market discount income until a bond is sold or redeemed. The capital-gain nature of market discount is highlighted in the case of distressed debt. In this case, when an investor buys a bond at a deeply discounted price due to credit deterioration of the issuer and then realizes a gain due to improvements in the issuer's credit condition, the gain is much more in the character of a capital gain than of interest income. The administration recognizes this point in its explanation of its proposal.[4]

The administration has proposed that accrual taxpayers be required to recognize the accrual of market discount as it occurs and to incur tax liability on market discount annually. As a result, the proposal would exacerbate problems and inconsistencies associated with current-law treatment of market discount.

First, the proposal would introduce significant complexity to the treatment of market discount. As the JCT staff recognizes, when the existing market discount provisions were adopted in 1984, Congress purposefully established the current scheme of treatment—incurring tax liability only when a bond is sold or redeemed—in recognition that annual accrual treatment would be too complex.[5] The problem of complexity is compounded, as the JCT staff also recognizes, when a bond carries both original-issue discount and market discount. The complexity of the market discount rules were highlighted in 1993, when the treatment of market discount on municipal bonds was changed from capital gain to ordinary income. This provision caused significant confusion among municipal bond investors.

Second, the administration's proposal would reduce the attractiveness of bonds trading at a discount to investors who are accrual taxpayers. Unfortunately, the tax treatment of market discount becomes an increasing concern to investors at times of market uncertainty, when bond prices are declining as a result of rising interest rates and when, as a result, market liquidity is hampered. Imposing additional, negative tax consequences on buyers of discounted debt instruments would simply fuel the illiquidity fire. This problem is compounded in times of persistent and severe declines in bond prices. It would be possible in these conditions for certain investors to pay tax annually on the accrual of market discount when, because the value of the bond fails to increase as fast as the discount accrues, little no real cash income is ever actually earned. In such severe cases, an investor would be forced to recognize the accrual of market discount as ordinary income, even though that income was actually absorbed in a capital loss. Although this mistreatment exists under current law, it would be exacerbated if accrual taxpayers are forced to recognize market discount annually.

Defer interest deduction and original issue discount on certain convertible debt

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that "the issuance of convertible debt instrument[s] is viewed by market participants as a de facto issuance of equity."[6] However, performance does not bear this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound prob-

[4] Ibid., Page 121.
[5] Staff of the Joint Committee on Taxation, Page 207.
[6] Department of the Treasury, page 127.

lems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, we urge the rejection of the administration's proposal.

Deny DRD for preferred stock with certain non-stock characteristics

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed eliminating the dividends-received deduction (DRD) for preferred stock with certain characteristics. This proposal would increase the taxation of corporate earnings and discourage capital investment.

The DRD is important because it reduces the effects of multiple taxation of corporate earnings. When dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

The administration has argued that certain types of preferred stock, such as variable-rate and auction-set preferred, "economically perform as debt instruments and have debt-like characteristics."[7] However, the administration has not proposed that such instruments be formally characterized as debt eligible for interest payment and accrual deductions. The administration has sought to characterize certain preferred stock in such a way as to maximize tax revenue; it would be ineligible for both the DRD and the interest expense deduction.

Eliminating the DRD for these instruments would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain investors would fall. This tax increase would flow directly to issuers of preferred stock affected by the proposal who would face higher financing costs as investors demanded higher pre-tax yields. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. Eliminating the DRD for preferred stock with certain characteristics would cut U.S. corporations off from an efficient source of financing, thereby discouraging capital investment.

New Budget Initiatives

Provide Tax Credits for Holders of Qualified School Modernization Bonds and Qualified Zone Academy Bonds and Provide Tax Credits for Holders of Better America Bonds

The administration has proposed policy initiatives significantly expanding the use of "tax credit bonds." Under this new financing structure, states and localities would be able to issue qualified debt securities for targeted projects, including the construction and rehabilitation of public primary and secondary school facilities and for certain environmental uses. Investors in the bonds earn federal income tax credits, presumably in lieu of interest payments by the issuers.

Qualified Zone Academy Bonds.—In 1997, Congress passed and the President signed H.R. 2014 (P.L. 105–34), a budget reconciliation bill which included the Taxpayer Relief Act of 1997. Section 226 of the bill provides tax credits for holders of "Qualified Zone Academy Bonds" (QZABs). QZABs are bonds which may be issued by state and local governments to finance rehabilitation projects for public primary and secondary schools located in empowerment zones or enterprise communities or where at least 35 percent of students qualify for subsidized lunches under the National School Lunch Act. QZABs represent the first use of "tax credit bonds" to provide assistance for a designated public policy goal.

Although the goals of the QZAB program are laudable, the structure of the QZAB provision has seriously hindered its usefulness to school districts. Although some problems with the program are inherent in the tax credit bond structure, there are several notable problems with QZABs in particular.

[7] Ibid., page 132.

The program is very small.—The Taxpayer Relief Act authorized only $400 million of QZAB issuance per year for two years. This $400 million amount is allocated among all the states, so any one state receives a relatively small allocation. In 1999, for example, the District of Columbia is permitted to issue a total of only $1.2 million of QZABs. The small size and short term of the program causes several problems. First, it is difficult for bond issuers, attorneys, underwriters, investors and others associated with capital market transactions to commit resources to developing expertise on a new and unknown financing vehicle when very little issuance will be permitted to take place. Second, the small issuance volume ensures that there will be no significant secondary market for QZABs. A lack of market liquidity discourages investors and raises costs for issuers.

The program requires "private business contributions."—In order to qualify for QZAB financing, a school district must secure a "private business contribution" to the project being financed. The contribution must comprise at least 10 percent of the proceeds of the QZAB issue. The contribution can take the form of property or services. In practice, it has been prohibitively difficult for school districts to secure private business contributions needed to qualify for QZAB financing.

The credit rate is reset monthly.—The tax credit rate—the rate that determines the amount of tax credit earned by holders of QZABs—is set by the Treasury department monthly. This reset period is too infrequent to allow for efficient pricing and issuance of QZABs. Market interest rates change daily, even hourly, so a monthly reset period virtually ensures that the current credit will bear little relation to current market yields. Moreover, the credit rate is set at 110 percent of the "applicable federal rate" (AFR). This rate, however, does not necessarily reflect the actual rate of return that investors would demand in order to buy QZABs at a price that would leave the issuer with a no-cost source of capital.

Investors are limited.—Only three classes of investors are permitted to earn federal income tax credits by holding QZABs, banks, insurance companies and "corporations actively engaged in the business of lending money." Individual investors, a potentially strong source of demand for tax-preferred investments, are excluded as QZAB investors.

New construction is not eligible.—The QZAB program provides assistance only for the rehabilitation of existing school facilities. Construction of new schools is not eligible for QZAB financing. School districts whose capital investment plans include primarily the construction of new schools are not helped significantly by the program.

These problems, along with other issues related to tax credit bonds generally (see below), have crippled the QZAB program. To date, only three QZAB transactions have taken place. Moreover, the two publicly offered issues sold at a discounted price. In other words, in neither case did the school district receive a zero-percent interest rate, as the QZAB program is intended to provide. In both cases, issuers had to offer significant original issue discount, in addition to the federal tax credits, in order to attract investors.

New Initiatives

In its FY200 budget, the administration has proposed a significant expansion of tax credit bonds for school construction and rehabilitation and environmental purposes. First, in recognition of the severe limitation that the "private business contribution" imposes on the QZAB program, the administration has proposed a tax credit for corporations that provide contributions to qualified zone academies located in empowerment zones and enterprise communities equal to 50 percent of the value of the contribution. Each empowerment zone would be able to allocate $4 million in credits and each enterprise community would be allowed to designate $2 million of credits. This proposal may make it easier to attract private business contributions for QZAB-financed projects.

Second, the administration has proposed expanding the QZAB program. Under the administration's proposal, eligible school districts could issue $1 billion of QZABs in 2000 and $1.4 billion in 2001. The program would be expanded to include school construction as well as rehabilitation. Eligibility requirements for QZAB projects, including the private business contribution, would remain the same. The QZAB structure would be changed to bring it into line with other proposed tax credit bond programs. (See below.)

Third, the administration has proposed new tax credit bond programs for school construction and renovation, Qualified School Modernization Bonds (QSMBs), and for greenspace preservation and other environmental uses, Better America Bonds (BABs). Although the QSMB and BAB proposals attempt to remedy some of the problems with QZABs, they would also impose new requirements on states and localities that do not apply under the QZAB program. The administration's proposal stipulates that the Education Department would be required to approve the school modernization plan of any state or school district that used QSMBs. The Environmental Protection Agency (EPA) would be required to approve all projects funded with BABs.

The QZAB program provides a simple allocation formula based on state populations of individuals living below the poverty line. The proposed QSMB program, although much larger than the QZAB program, imposes more stringent allocations. The administration proposes $11 billion of QSMB issuance per year in 2000 and 2001. Half of this volume would be allocated to the 100 school districts with the largest number of children living below poverty. The Education Department would also be able to designate an additional 25 school districts which "are in particular need of assistance." The other half would be allocated among the states based on funding currently received under the Education Department's Title I grant program. Other allocations would be reserved for U.S. possessions and for schools funded by the Bureau of Indian Affairs. BABs would presumably be allocated by the EPA competitively on a project-by-project basis.

The Proposed New Structure for Tax Credit Bonds

In its FY 2000 budget, the administration proposes a new structure for all tax credit bonds. This new structure would apply to QZABs issued after December 31, 1999, QSMBs and BABs. In general, the structure is designed so that investors would buy tax credit bonds at face value—with no original issue discount—and with no pledge of interest payments by the issuer. If it works as designed, all of an investor's return would be earned in the form of the tax credit. The issuer is supposed to receive a zero-percent cost of capital.

Under the proposal, any taxpayer could claim a credit associated with holding a tax credit bond. Bondholders would become eligible to claim the credit annually on the anniversary date of a bond's issuance. Tax credits would be treated as taxable interest and would be included in a taxpayer's gross income calculation. The maximum term of a tax credit bond would be 15 years. Credits would be non-refundable, but could be carried forward for up to five years. The credit rate would be set daily rather than monthly, as under the current QZAB program. The credit rate would be based on prevailing market yields in the corporate bond market. An issuer selling tax credit bonds would use the tax credit rate published by the Treasury Department on the day prior to the day the bonds are sold.

Tax Credit Bonds and the Capital Markets

Although the administration's proposed new structure for tax credit bonds is an improvement over the structure used in the current QZAB program, from a market perspective, there are flaws inherent in any tax credit bond which would result in significant inefficiencies. Perhaps the most significant involves the timing of tax credits and the nature of the investment return sought by bond investors.

With a traditional bond that pays cash interest, the yield calculation used by investors to price the value of a bond assumes that investors will receive interest payments according to a specified schedule and that investors will have the opportunity to reinvest those payments immediately. In the standard yield or price calculation, there is no time when any portion of an investor's return is not generating income. In contrast, the value of a tax credit under any of the proposed tax credit bond proposals is largely dependent on timing and on the tax situation of a particular investor. Under the administration's proposal, an investor earns the ability to take an annual credit on the anniversary date of a bond's issuance. However, the credit becomes economically valuable to the investor only when it has the effect of reducing a tax payment, and that occurs only on a day when an investor is required to make a federal tax payment. For some investors, tax payment dates occur only once per year. In the likely occurrence that the anniversary date does not coincide with a tax payment date, the investor incurs a period of time when the credit has no significant economic value. Because no money has changed hands, it is not possible for the investor to "reinvest" the credit as he or she could with a cash interest payment. The investor loses the reinvestment income that normally begins accruing on an interest payment date.

The situation worsens in years when a tax credit bond investor has no tax liability whatsoever. Under the administration's proposal, tax credits may be carried forward for up to five years. However, if an investor has no tax liability in a given year and is forced to carry the credit forward, the period of time during which the credit provides no economic value is extended even further. Again, until an investor is able to earn true economic value from the credit through a reduction in a tax payment, the reinvestment potential normally associated with interest payments is lost. This substantially erodes the value of the investment. These timing problems make it exceedingly difficult to efficiently price the value of a tax credit bond and introduces inefficiencies to the structure. Indeed, the value of the bond differs from investor to investor, depending on their tax circumstances.

A second problem associated with the tax credit bond proposal involves the overall size of the program. The overall volume of tax credit bond issuance would increase substantially under the administration's various proposals. Taken together, the QZAB, QSMB and BAB proposals would authorize the issuance of nearly $29 billion of tax credit bonds over five years. In the context of the capital markets overall, however, this is a relatively small volume of issuance, especially given the novelty of the financing structure. In contrast, in 1998 alone, states and localities issued $286 billion of traditional municipal bonds. The relatively small size of the tax credit bond market would ensure that little secondary market trading took place. Tax credit bonds would be illiquid instruments. As a result, investors would demand a liquidity premium—a higher rate of return—from bond issuers.

A third problem with tax credit bonds relates to the timing and value of the credit rate. The administration has proposed to set the credit rate on a daily basis using prevailing market yields in the corporate bond market. Tax credit bond issuers would use the previous day's credit rate when pricing and selling their bonds. However, market interest rates change from day to day and even from minute to minute. It is unlikely that the interest rates used on Monday to set the credit rate would still prevail on Tuesday, when an issuer came to market with a bond issue. If rates have risen, issuers would have to make up the difference by offering a discounted price on their bonds.

Market professionals have also expressed concerns about the credit rate itself and the attractiveness to investors of tax credit bonds with credit rates based on corporate bond yields. Because they would be priced and sold to investors based on corporate bond rates of return, they would compete for capital with corporate bonds themselves and similar taxable investments. However, because they are tax-preferred investments, tax credit bonds would be of little value to tax-exempt or tax-deferred investors such as pension funds, retirement accounts and foreigners, groups of investors which are very active in the U.S. taxable bond markets. The only investor groups to whom tax-credit bonds would be attractive are domestic individuals and corporations, largely banks and insurance companies, since they are most active in the capital markets as investors.

For individual investors, tax-credit bonds would compete with tax-exempt municipal bonds and taxable corporate bonds. For many individual investors, municipal bonds provide a more attractive after-tax rate of return than corporate and similar taxable bonds. This stands whether the taxable investment pays cash interest or offers a tax credit at a rate based on prevailing corporate bond rates of return. It is unlikely that investors for whom tax-exempt municipal bonds provide a superior after-tax rate of return to corporate bonds would be attracted to tax credit bonds with yields based on the corporate market. Banks and insurance companies, who are active in the corporate bond market, would potentially find the credit rate appealing. However, the timing issues outlined above would make tax credit bonds with interest rates based on corporate bond yields less attractive than corporate bonds themselves. In short, it is likely that the pool of potential investors in tax credit bonds would be severely limited, given that tax-credit bonds would compete against corporate bonds themselves and similar taxable investments.

A fourth and final problem associated with the administration's proposals involves the degree to which federal agencies are required to approve projects before they qualify for tax credit bond financing. This approach runs counter to the flexibility and freedom enjoyed by states and localities in planning, financing and executing their construction projects. It is virtually unheard of for a local school district to seek federal approval before proceeding with a construction project. Injecting a high degree of federal control in the financing process would discourage school districts from taking advantage of the tax credit bond programs.

In sum, given the problems associated with tax credit bonds outlined above, it is highly unlikely that any state or local government would obtain a zero-percent cost of capital through a tax credit bond. Given the inefficiencies built into the tax credit bond structure, states and localities would invariably be forced to sell bonds at a discount to attract investor interest. The difference between the sale price of tax credit bonds and their face value would represent interest cost to the issuer in the form of original issue discount.

An Alternative—Tax-exempt Financing

Tax-exempt bonds are the single most important source of financing for state and local investment in public school infrastructure. Over the past decade or so, tax-exempt bonds have financed approximately 90 percent of the nation's investment in public schools. Tax-exempt bonds are efficient, well-understood, popular among investors, and have an established market infrastructure with a several-hundred-year history beginning in colonial times. Moreover, tax-exempt bonds provide an important source of federal assistance from the federal government to states and localities. Because the federal government foregoes the tax revenue on interest earned by investors on qualified municipal bonds, investors demand a much lower rate of interest than they otherwise would. States and localities benefit through a lower cost of capital.

Tax-exempt bonds are not plagued by any of the problems that would affect the success of tax credit bonds. Because they pay cash interest, municipal bonds are not affected by the timing issues that would erode the value of tax credit bonds. Because it is a large and established market with a broad base of investors, secondary market trading is relatively active and liquid. Interest rates are set efficiently according to market-based rates of return, and issuers do not need any form of federal approval to tap the capital markets.

As beneficial as tax-exempt bonds are in helping school districts finance construction and rehabilitation, the federal tax code contains a number of restrictions on the issuance and use of tax-exempt bonds that prevent school districts from using municipal bonds to their full potential. Congress has considered and is considering several targeted changes to improve the ability of school districts to use tax-exempt bonds to finance school construction. These proposals would address restrictions related to private use, arbitrage, refinancings and restrictions on investing in school bonds. They would provide meaningful assistance to school districts by lowering the cost of financing for school construction projects. The proposals would result in more schools being built and repaired and would, in some cases, accelerate construction projects that are on school districts' capital investment plans.

On February 4, Chairman Archer announced his support for an initiative to extend from two years to four the construction spend-down exemption from arbitrage rebate rules for school bonds. In announcing this initiative, Chairman Archer correctly recognized that addressing existing impediments to the broader use of tax-exempt bonds for school construction would go a long way towards encouraging and assisting local school districts to build more schools faster. We fully support Chairman Archer's proposal and we urge Congress to enact it quickly. We also urge Congress to consider, as an alternative or supplement to tax-credit bonds, other targeted changes to municipal bond rules for school bonds to spur public school construction and rehabilitation.

SUMMARY

Government fiscal policy, especially tax policy, can have a profound effect on the ability of governments and corporations to undertake capital investment. Tax increase proposals as seemingly arcane, technical and focused as "increasing the proration percentage for property and casualty companies" or "disallowing interest on debt allocable to tax-exempt obligations" would have effects far beyond what is apparent. By affecting the choices and preferences of investors, these proposals would also have a significant negative effect on the ability of borrowers to finance capital investments at the lowest possible cost. We share the belief of many members of this committee that our tax system ought to encourage and facilitate capital investment. The administration's tax increase proposals outlined above would have the opposite effect. We urge you to oppose these provisions.

We agree with the administration's goals in other areas. We agree, for example, that tax incentives designed to assist and encourage school districts to build and rehabilitate public schools are appropriate. Unfortunately, it appears that the administration's tax credit bond initiatives would fail to achieve the goal of providing state and local governments with a zero-interest source of capital. We urge Congress to explore alternative ways to expand traditional municipal bond financing for school construction and rehabilitation.

We appreciate the opportunity to present our statement, and we look forward to working with Ways and Means members and staff as the budget debate progresses.

Statement of Business Insurance Coalition

AIG Life Companies (U.S.)
American Council of Life Insurance
American General Corporation
America's Community Bankers
Association for Advanced Life Underwriting
Business Use Insurance Committee
Clarke/Bardes, Inc.
Harris, Crouch, Long, Scott & Miller, Inc.
Massachusetts Mutual Life Insurance Company
MetLife
National Association of Life Underwriters
New York Life Insurance Company
Pacific Life
Security Life of Denver Insurance
Southland Insurance Company

The Business Insurance Coalition, which is comprised of the above-listed purchasers, issuers, and sellers of business-use life insurance, submits this statement opposing the Administration's FY 2000 budget proposal to impose new taxes on businesses that own or benefit from permanent life insurance.

American businesses, large and small, have for many decades used life insurance to assure business continuation, provide employee benefits and attract and retain key employees. There is no justification for discouraging or eliminating these traditional business uses of life insurance. The Administration has again proposed—as it did last year—a heavy tax on life insurance held by businesses that would strongly discourage the vast majority of employers from utilizing this important product. We urge Members of the Ways and Means Committee to reject it once again.

Life Insurance Allows Business Continuation, Protects Employees and Funds Vital Employee Benefit Programs

Permanent life insurance protects businesses against the economic losses which could occur after the death of an owner or employee. Life insurance death benefits provide liquid cash to pay estate taxes upon the death of a business owner, to buy out heirs of a deceased owner or to meet payroll and other ongoing expenses when an income-producing worker dies.

Permanent life insurance purchased with after-tax dollars smoothes the transition during difficult times, allowing the business—and its employees—to continue working by preventing or mitigating losses associated with these disruptions. Anecdotal evidence of this abounds; every Representative and Senator will hear from constituents whose jobs still exist because their employers were protected from financial loss by life insurance.

Many businesses, both large and small, also use permanent life insurance to finance employee benefit programs, thus enabling them to attract and retain their most important asset: skilled, experienced employees. Insurance-financed benefit programs are as diverse as the companies that use them, ranging from those which provide broad-based health coverage for retirees to non-qualified pensions and savings benefits.

The Proposal Reverses Recent Congressional Action by Imposing New Taxes on Business-Use Life Insurance

The Administration's FY 2000 budget proposal would severely impact all of the aforementioned business uses of life insurance. Under the proposal, any business with general business debt unrelated to insurance would lose part of its deduction for interest paid on that debt simply because the business owns, or is the beneficiary of, permanent life insurance. The business' interest deduction would be reduced by an amount related to the net unborrowed cash values in such policies (except for those covering the lives of 20 percent owners). This would impose an indirect tax on accumulating cash values of the insurance—as unborrowed cash values increase, the business' interest deduction disallowance would correspondingly increase.

The Administration proposal would repeal specific exceptions to a 1997 rule enacted by Congress which generally disallows a portion of a business' deduction for interest paid on unrelated borrowing where the business directly or indirectly benefits from insurance covering the lives of anyone but an employee, officer, director or 20 percent or greater owner. The pending proposal would remove all exceptions except that applicable to 20 percent owners.

Last year, the Administration made the same proposal, which seeks to overturn current law developed after three years of Congressional examination into appropriate business uses of life insurance. It again asks Congress to reconsider its 1996 and 1997 determinations that there is no inappropriate interrelationship between owning (or benefiting from) life insurance on employees, officers and directors and general, unrelated borrowing decisions. More broadly, the proposal seeks to repeal long-standing tax policy which confers on corporations the right to enjoy the same important insurance tax benefits that are available to individuals.

THE ADMINISTRATION PROPOSAL WOULD SEVERELY IMPACT BUSINESSES THAT RELY ON LIFE INSURANCE

Enactment of the Administration proposal would make it significantly—in most cases, prohibitively—more expensive for businesses to own permanent life insurance. This would increase the number of inadequately protected businesses, which would, in turn, cause more businesses to fail when their owners and/or key workers die (a result directly at odds with the effort to save family-owned businesses as ongoing entities in the estate tax debate).

The Administration proposal also would stifle business expansion and job creation by placing an arbitrary tax on normal corporate indebtedness of companies that own life insurance. The net effect would be to increase the cost of business expansion and discourage business growth, which is both bad economic and tax policy.

If enacted, the Administration proposal also would make it more difficult, perhaps impossible, for many businesses to use life insurance in connection with employee and retiree benefits. It would hurt employees by unduly restricting the benefits companies can provide to key workers. It would hurt businesses by making it more difficult to attract and retain quality employees.

Finally, the Administration proposal would impose a double tax penalty on certain business policyholders forced to surrender or sell their life insurance policies. The first tax penalty would be paid through reduced interest deductions on the business' unrelated borrowing. The second tax penalty would occur upon surrender of the policy, which the retroactive application of the Administration's new tax on existing policies would be certain to trigger. The business would again be required to pay tax on the gain generated inside the policy. Plainly, there is no justification for imposing two taxes (a proration tax and a tax on policy surrender) with respect to the same item of income (life insurance inside build-up).

THE ADMINISTRATION'S "ARBITRAGE" JUSTIFICATION IS WITHOUT MERIT

The Administration asserts that tax legislation is needed to prohibit "arbitrage" with respect to cash value life insurance. This is not the case. Current law (IRC section 264) disallows the deduction of interest on "policy indebtedness" and has always applied to direct borrowing (policy loans) and indirect borrowing (third party debt) where the debt is used to "purchase or carry" life insurance.

What remains outside of section 264, then, is solely debt that is unrelated to a business' decision to "purchase or carry" life insurance, such as a manufacturer's mortgage to purchase a new plant or a travel agency's loan to buy a new copy machine. Under the Administration's proposal, these businesses would be penalized for protecting themselves against the premature death of key persons or funding retiree health benefits through life insurance, even if they have neither borrowed funds to purchase the policies nor taken out loans against the policies. If the Administration's logic were applied to individual taxpayers, homeowners would lose their ability to deduct interest on their home mortgage loans because they also own permanent life insurance.

Current tax law is designed to capture situations involving arbitrage with respect to cash value life insurance. The Administration's attempt to characterize any form of debt as leverage which renders a business' purchase of life insurance tax "arbitrage" is nothing but smoke and mirrors designed to hide its true purpose: the imposition of new taxes on business-use life insurance.

THE ADMINISTRATION'S CHARACTERIZATION OF BUSINESS INSURANCE AS A TAX SHELTER IS NONSENSE

The tax attributes of life insurance are clearly defined by the Internal Revenue Code, of which they have been a part for many years. Those attributes have been the object of study by Congress from time to time and refinement of some of the ancillary rules. The fundamental tax attributes have remained unchanged, however, and they are well understood.

As noted above, life insurance has long been used by businesses to assure business continuation, provide employee benefits, and attract and retain key employees. These business uses of life insurance are also well known. Indeed, they have been examined exhaustively by the Congress in each of the last three years.

In 1996, Congress examined business life insurance and made adjustments with respect to policy loans. It did so again in 1997, when it imposed limitations on life insurance covering the lives of non-employees. Both times, Congress left alone traditional uses of life insurance by businesses. In 1998, Congress again examined business life insurance, this time rejecting the very proposal the Administration again makes this year to impose a new tax on all forms of cash value life insurance held by business by denying a deduction for interest on unrelated debt.

It is therefore surprising that the Administration now seeks to characterize business insurance as a tax shelter. At the heart of the Administration's tax shelter proposals is the concept of a "tax avoidance transaction." Mere ownership of life insurance, the tax attributes of which are longstanding and well known, plainly cannot be such a transaction.

More specifically, the Administration makes it clear in its tax shelter proposals that a tax shelter does not include any "tax benefit clearly contemplated by the applicable provision." Department of the Treasury, General Explanation of the Administration's Revenue Proposals at 96 (February 1999). The tax attributes of life insurance are not only clearly contemplated and well understood—they were precisely the attributes examined at length by Congress in 1996, 1997 and 1998.

The Administration's proposal is to impose a new tax on traditional business uses of life insurance, and nothing more. It should be considered—and rejected—on its merits, and not based on the Administration's incongruous and entirely inappropriate characterization of life insurance as a "tax shelter."

Tax Policy Should Encourage Appropriate Business-Use Life Insurance Programs

At the heart of the debate over the Administration's proposal is the issue of whether business uses of life insurance should be encouraged or discouraged. The Business Insurance Coalition fundamentally disagrees with the Administration's position, which threatens all present and future uses of life insurance by businesses, and its members firmly believe that business-use life insurance falls clearly within the policy purposes supporting the tax benefits presently accorded to life insurance products.

Tax policy applicable to business-use life insurance should encourage appropriate use of business life insurance by embodying the following principles:

- Businesses, in their use of life insurance, should have the benefit of consistent tax laws in order to facilitate reliable and effective long-range planning.
- All businesses, regardless of size or structure, should be able to use life insurance to provide benefits for their workers. Life insurance is an appropriate method of facilitating provision of retirement income, medical and survivorship benefits.
- Businesses must be able to use life insurance as an important part of their financial protection plans, and the insurance industry should respond to new business needs.
- Businesses, like individuals, should be able to use all products which qualify as life insurance under applicable federal and state law.
- Businesses should be able to use life insurance products in ways consistent with the public interest and the intent of the tax laws.
- Businesses should be able to use life insurance to protect against the financial loss of the insured's death, or to meet other financial needs or objectives, including but not limited to:

—successful continuation of business operations following the death of an insured key employee;

—purchase of a business interest, thereby enabling the insured's family to obtain a fair value for its business interest and permitting the orderly continuation of the business by new owners;

—redemption of stock to satisfy estate taxes and transfer costs of an insured stockholder's estate;

—creation of funds to facilitate benefits programs for long-term current and retired employees, such as programs addressing needs for retirement income, post-retirement medical benefits, disability income, long-term care, or similar needs; and

—payment of life insurance or survivor benefits to families or other beneficiaries of insured employees.

Businesses Need Reliable and Predictable Tax Rules to Guide Their Financial Decisions

Life insurance is a long-term commitment. It spreads its protection—and premium obligations—over life spans, often 40 or 50 years. Its value base is predicated on the lifetime income-producing potential of the person insured. Thus, the process of selecting, using and paying for permanent insurance is one that contemplates decades of financial planning implications.

Accordingly, the rules governing the choices inherent in constructing a business-use life insurance program must be clear and reliable. Certainty of rules that drive the configuration of decades-long financial commitments is crucial. There must be a stable environment that acknowledges long-established practices.

This need is even more acute today because of the Congressional actions of 1996 and 1997, which created a virtual "road map" for businesses to follow in designing and implementing their business-use life insurance programs. The two years of debate addressed business-use life insurance practices in substantial detail, settling all of the issues raised by the pending Administration proposal. Thus, businesses reasonably thought they could proceed with some certainty under the rules enacted in 1996 and then further refined in 1997. To reopen these issues—which were addressed and settled less than two years ago—and then to change them again would be unconscionably unfair.

Conclusion: The Administration's Business-Use Life Insurance Proposal Unfairly and Adversely Affects Every Business with Current or Future Debt

The Business Insurance Coalition strongly opposes the Administration's FY 2000 budget proposal on business-use life insurance, which unfairly and adversely affects every business that has current or future debt unrelated to its ownership of life insurance. The Business Insurance Coalition has demonstrated the appropriateness of the current rules governing business-use life insurance, which underpins business continuation and employee protection.

Life insurance that protects businesses against the loss of key personnel and/or facilitates the provision of employee benefits should not be subject to further changes in applicable tax law. The question before Congress should be: Do current uses of business life insurance serve legitimate policy purposes justifying the tax benefits accorded life insurance generally? We believe that this question should be answered with an emphatic "YES," and urge the Committee to again reject the Administration's proposal to impose new taxes on business-use.

Statement of Business Roundtable

I am Thomas Usher, chief executive officer of USX Corporation and chairman of the Taxation Task Force of The Business Roundtable. I am testifying in writing to the views of The Business Roundtable on tax legislation for 1999. The members of The Business Roundtable are chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States.

In the United States, corporations employ more people, pay more wages, fund more research, invest in more plant and equipment, and support more employee benefits than any other type of business. We also pay more federal income tax. Therefore, one of our main public policy interests is how taxes are affecting corporations in their central economic role as engines pulling the national economy.

From that perspective, we urge Congress to reduce the corporate income tax. Corporate funds that are not diverted to taxes can go into building the economy and underwriting prosperity in future years. The old saying is true: the time to invest is when you have it. The condition of the federal budget, itself a beneficiary of economic growth, makes a corporate tax reduction feasible.

Lowering the corporate income tax rate would be the most effective form of corporate tax reduction. It would affect all types of corporations. It would put funds into play to compete for economic projects that have the best prospects for creating value and stimulating growth. The alternative is for the government to pick business winners based on politics and thus dilute the beneficial impact of a business tax reduction.

The top corporate income tax rate is 35 percent. It is in the 30's today rather than the 20's as the result of tax reform politics in 1986 and not for any reason of tax or economic policy. The original tax reform ideal was to broaden the tax base and lower tax rates so that the net change was revenue neutral. If Congress had applied this principle to the corporate income tax in the Tax Reform Act of 1986, the top corporate tax rate would have been 26 or 27 percent. But to obtain support for tax reform in 1986, the government enacted more than a 20 percent corporate tax increase so that it could cut individuals' taxes in the same amount.

Other broad improvements to the federal corporate income tax would allow businesses to create additional value. These improvements include simplification of tax rules governing international business; a permanent tax credit to encourage research and experimentation so that the credit functions more effectively, as all commentators on the subject have observed; and alternative minimum tax relief so that heavy-investing companies are not penalized and capital can flow into job-producing uses rather than prepayment of income tax.

Constructive measures like cutting corporate tax rates and simplifying international tax rules stand in stark contrast to the Administration's proposals to increase taxes on business. Corporations are singled out in certain proposals that have soundbite appeal but only magnify the worst tendencies of the tax system to complicate, confuse, and retard economic growth. Each of these revenue-raising proposals regarding global operations, exports, corporate tax planning, tracking stock, and punitive damages is objectionable on its own and should be rejected. Together these proposals represent an additional tax burden on American business that is anti-competitive in the global marketplace.

We would have thought it axiomatic that U.S. tax policy should not handicap U.S. enterprises in the international contest for business. But the Administration's proposals would have a particularly harsh impact on international operations. They could be employed by IRS agents to deny foreign tax credits and interest deductions where corporate structures are debt-financed. They would add significantly to the tax burden of U.S. multinationals and make it impossible for them to operate with certainty regarding the tax treatment of their global operations. The proposal to repeal the "export sales source rule" would increase taxes sharply on U.S. companies that export goods overseas.

The Administration's proposal to tax the issuance of tracking stock is unprecedented. Such a tax would constitute the only direct tax on the issuance of common stock. Companies use tracking stock for compelling business reasons: to raise capital efficiently to grow or acquire businesses, to attract and retain employees, and to satisfy investor demands. The imposition of a tax on the issuance of tracking stock would constrict new business technology investment, disrupt financial markets, cost jobs, and require massive financial re-engineering for some companies.

In the name of attacking "corporate tax shelters" the Administration would give IRS auditors unprecedented authority to impose taxes and penalties on almost any business transaction where tax-planning considerations may have played a role. These proposals could affect a wide range of legitimate business transactions undertaken in the ordinary course of business. The proposals would compromise the rights of taxpayers to pay no more than the minimum amount they owe under the tax laws and overlook the ample tools the government already possesses to address abuses of the tax system. The proposals are even more surprising coming so soon after the Administration itself found it necessary to rein in undesirable practices of IRS agents and reform the IRS.

It is accepted in tax theory and in the actual practice of our global competitors to allow business deductions against income. Yet the Administration proposes to deny deductions for punitive damages paid by corporations upon judgment by a court or upon settlement of a claim. It is particularly unfair given our litigious society and given that the federal government has failed to enact any meaningful tort reform.

Finally, we would not have expected the Administration to propose a $20 billion corporate income tax increase over the same 5-year period that federal budget surpluses will amass to $953 billion.

Who will look to the bigger picture? We respectfully urge this Committee, this House of Representatives, and this Congress to close the book on fragmentary and narrow-gauged tax measures, like many of those in the Administration's budget, and to consider more visionary policies that promote the general economic welfare of this nation as it engages in the global contest for income and prosperity.

Thank you for considering our views.

Statement of Central & South West Corporation, Dallas, Texas

Mr. Chairman and Members of the Committee, we thank you for the opportunity to submit this statement on behalf of Central & South West Corporation of Dallas, Texas on the importance of extending the wind energy production tax credit (PTC) until the year 2004.

Central and South West Corporation (CSW) is an investor-owned electric utility holding company based in Dallas, Texas. CSW owns and operates four electric utilities in the United States: Central Power and Light Company, Public Service Company of Oklahoma, Southwestern Electric Power Company, and West Texas Utilities Company. These companies serve 1.7 million customers in an area covering 152,000 square miles of Texas, Oklahoma, Louisiana, and Arkansas.

CSW also owns a regional electricity company in the United Kingdom, SEEBOARD plc, which serves 2 million customers in Southeast England. CSW engages in international energy, telecommunications and energy services businesses through nonutility subsidiaries including CSW Energy, CSW International, C3 Communications, EnerShop, and CSW Energy Services. CSW is currently in the process of seeking regulatory approval for a merger with American Electric Power Company, based in Columbus, Ohio, and expects the merger to be completed sometime in the 4th quarter of 1999.

CSW has been active in the research and development of wind energy for six years, and was named as the American Wind Energy Association's Utility of the Year in 1996. CSW owns and operates the first wind farm built as part of the U. S. Department of Energy's Turbine Verification Program in which state-of-the-art, U.S.-manufactured wind turbine technology is being tested. In addition, a 75 MW wind farm is currently being built near the west Texas community of McCamey in order to serve the customers of three CSW subsidiaries—West Texas Utilities Company, Central Power and Light Company, and Southwestern Electric Power Company.

We want to commend Representative Bill Thomas, and all of the cosponsors of H.R. 750, and Senators Grassley, Jeffords and Conrad and all of the cosponsors of S. 414, for their leadership in supporting legislation to extend the wind energy PTC until the year 2004. H.R. 750 and S. 414 both have broad, bipartisan support. H.R. 750 was introduced with sixty (60) original cosponsors, including nineteen (19) members of this committee. H.R. 750 is now supported by 86 cosponsors including 23 of the members, a majority, of this committee.

We also want to commend President Clinton for including, and funding, a five-year extension of the wind energy PTC in the Administration's FY 2000 Budget.

We hope the Congress will take swift action to extend the wind energy PTC by enacting the provisions of H.R. 750—S. 414 before the expiration of the current PTC on June 30, 1999.

I. BACKGROUND OF THE WIND ENERGY PTC

The wind energy PTC, enacted as part of the Energy Policy Act of 1992, provides an inflation-adjusted 1.5 cents/kilowatt-hour credit for electricity produced with wind equipment for the first ten years of a project's life. The credit is available only if the wind energy equipment is located in the United States and electricity is generated and sold. The credit applies to electricity produced by a qualified wind energy facility placed in service after December 3, 1993, and before June 30, 1999. The current credit will expire on June 30, 1999.

II. WHY DO WE NEED A WIND ENERGY PTC?

A. The Wind Energy PTC is Helping to Drive Costs Down, Making Wind Energy a Viable and Efficient Source of Renewable Power

The efficiency of wind generated electric energy has increased dramatically since the early to mid–1980's. The machine technology of the 1980's was in its early stages and costs of wind energy during this time period exceeded 25 cents per kilowatt-hour. Since that time, however, the wind industry has succeeded in reducing wind energy production costs by a remarkable 80% to the current cost of about 4.5 cents/kilowatt-hour. The 1.5 cent/kilowatt-hour credit enables the industry to compete with other generating sources currently being sold at 3.0 cents/kilowatt-hour.

The industry expects that its costs will continue to decline as wind turbine technology and manufacturing economies of scale increase in efficiency. Through further machine development and manufacturing efficiencies, the wind energy industry anticipates the cost of wind energy will be further reduced to 3 cents/kilowatt-hour or lower by the year 2004, which will enable it to fully compete on its own in the marketplace.

The most significant factor contributing to the dramatic reduction in U.S. wind energy production costs over the years—since the 1980's—has been the dramatic improvement in machine efficiency. Since the 1980's, the industry has developed three generations of new and improved machines, with each generation of design improving upon its predecessor. As a result, reduced costs of production of new wind turbines, blade designs, computer controls, and extended machine component life have been achieved. Proven machine technology has evolved from the 50-kilowatt machines of the 1980's to the 750-kilowatt machines of today that have the capacity to satisfy the energy demands of as many as 150 to 200 homes annually. Moreover, a new 1500-kilowatt machine is currently undergoing the last phases of development and testing that will further improve the technology's efficiency and further reduce wind power costs to about 4 cents per kilowatt-hour.

The wind industry anticipates that wind energy production costs will continue to decline in the future, and is confident that the next two generations of wind turbine design—estimated to be available by the year 2004—will sufficiently lower the technology costs to allow the industry to fully compete in the United States on its own merits with fossil-fueled generation. The five-year extension of the wind energy production tax credit will bridge the gap for the domestic industry until it is fully able to stand on its own by the year 2004.

B. Wind Power will Play an Important Role in a Deregulated Electrical Market

The electrical generation market is going through significant changes as a result of efforts to restructure the industry at both the Federal and State levels. If the wind energy PTC is extended, renewable energies such as wind power are certain to play an important role in a deregulated electrical generation market. Wind power alone has the potential to generate power to as many as 10 million homes by the end of the next decade. Extending the credit will help the wind energy industry secure its position in the deregulated marketplace as a fully competitive, renewable source of electricity.

C. Wind Power Contributes to the Reduction of Greenhouse Emissions

Wind-generated electricity is an environmentally-friendly form of renewable energy that produces no greenhouse gas emissions. "Clean" energy sources such as wind power are particularly helpful in reducing greenhouse gas emissions. The reduction of greenhouse gas emissions in the United States will necessitate the promotion of clean, environmentally-friendly sources of renewable energy such as wind energy. The extension of the wind energy PTC will assure the continued availability of wind power as a clean, renewable energy source.

D. Wind Power has Significant Economic Growth Potential

1. Domestic

Wind energy has the potential to play a meaningful role in meeting the growing electricity demand in the United States. As stated above, with the appropriate commitment of resources to wind energy projects, wind power could generate power to as many as 10 million homes by the end of the next decade. There currently are a number of wind power projects operating across the country. These projects are currently generating 1,761 megawatts of wind power in the following states: Texas, New York, Minnesota, Iowa, California, Hawaii and Vermont.

There also are a number of new wind projects currently under development in the United States. These new projects will generate 670 megawatts of wind power in the following states: Texas, Colorado, Minnesota, Iowa, Wyoming and California.

The domestic wind energy market has significant potential for future growth because, as the sophistication of wind energy technology continues to improve, new geographic regions in the United States become suitable for wind energy production. The top twenty states for future wind energy potential, as measured by annual energy potential in the billions of kWhs in environment and land use exclusions for wind class sites of 3 and higher, include:

1.	North Dakota	1,210
2.	Texas	1,190
3.	Kansas	1,070
4.	South Dakota	1,030
5.	Montana	1,020
6.	Nebraska	868
7.	Wyoming	747
8.	Oklahoma	725
9.	Minnesota	657
10.	Iowa	551
11.	Colorado	481
12.	New Mexico	435
13.	Idaho	73
14.	Michigan	65
15.	New York	62
16.	Illinois	61
17.	California	59
18.	Wisconsin	58
19.	Maine	56
20.	Missouri[1]	52

Source: An Assessment of the Available Windy Land Area and Wind Energy Potential in the Contiguous United States, Pacific Northwest Laboratory, 1991.

Sixteen states, including our home state of Texas, have greater wind energy potential than California where, to date, the vast majority of wind development has taken place.

a. Wind Power Projects can Serve as a Supplemental Source of Income for Farmers

As discussed above, the increasing sophistication of wind energy technology has opened up new regions of the country to wind energy production. One area of the country that has been opened up to wind power production over the last few years is the Farm Belt. Since wind power projects and farming are fully compatible—a wind power plant can operate on land that is being farmed with little or no displacement of crops or livestock—wind power projects are now be sited on land in the Farm Belt that is also being used for crop and/or livestock production. The land rent paid by wind project developers is a valuable source of additional income for farmers. For example, a new wind plant soon to go on line in Clear Lake, Iowa will pay rent to fourteen different landowners who will be supplementing their income by leasing their land for the operation of the plant without disrupting their ongoing farming operations. This is a win-win situation for both farmers and consumers in Iowa.

2. International

The global wind energy market has been growing at a remarkable rate over the last several years and is the world's fastest growing energy technology. The growth of the market offers significant export opportunities for United States wind turbine and component manufacturers. The World Energy Council has estimated that new wind capacity worldwide will amount to $150 to $400 billion worth of new business over the next twenty years. Experts estimate that as many as 157,000 new jobs could be created if United States wind energy equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Only by supporting its domestic wind energy production through the extension of the wind energy PTC can the United States hope to develop the technology and capability to effectively compete in this rapidly growing international market.

E. THE IMMEDIATE EXTENSION OF THE WIND ENERGY PTC IS CRITICAL

Since the wind energy PTC is a production credit available only for energy actually produced from new facilities, the credit is inextricably tied to the financing and development of new facilities. The financing and permitting requirements for a new wind facility often require up to two to three or more years of lead time. With the credit due to expire in less than four months, June 30, 1999, wind energy developers and investors are unable to plan any new wind power projects. The immediate extension of the wind energy PTC is therefore critical to the continued development and evolution of the wind energy market.

III. CONCLUSION

Extending the wind energy PTC for an additional five years is critical for a number of reasons. The credit enables wind-generated energy to compete with fossil fuel-generated power, thus promoting the development of an industry that has the potential to efficiently meet the electricity demands of millions of homes across the United States. If the wind energy PTC is extended, wind energy is certain to be an important form of renewable energy in a deregulated electrical market, and is an environmentally-friendly energy source that can aid in the reduction of greenhouse gas emissions. The economic opportunities of the wind energy market are significant, both domestically and internationally. As such, we urge Congress to act quickly to extend the wind energy PTC until the year 2004 so that the industry can continue to develop this important renewable energy resource.

Thank you for providing us with this opportunity to present our views on the extension of the wind energy PTC.

Statement of Coalition for the Fair Taxation of Business Transactions [1]

The Coalition for the Fair Taxation of Business Transactions (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries. The Coalition is opposed to the broad-based "corporate tax shelter" provisions in the Administration's budget because of their detrimental impact on legitimate business transactions. The Coalition is particularly concerned with the broad delegation of authority provided to IRS agents under these proposals, which we believe reverses some of the reforms of the IRS Restructuring and Reform Act, passed just last year.

INTRODUCTION

The Administration's Fiscal Year 2000 Budget contains several proposals addressing so-called "corporate tax shelters." The proposals fall into two general categories. The first is a set of broad-based proposals that could result in multiple penalties for any corporation that engages in a transaction that results in any reduction of taxes. The second is a set of specific proposals targeted at specific transactions that Treasury and the IRS view as abusive or inappropriate. These proposals, especially the set of broad-based proposals, appear to be driven by a perception on the part of Treasury and the IRS of a substantial increase in "corporate tax shelter" activity in recent years and that such activity has caused a serious erosion in the corporate tax base.

As a general matter, the Coalition does not believe that there has been a substantial erosion of the corporate tax base. Statistics recently released by the Congressional Budget Office (CBO) [2] demonstrate that, rather than falling, corporate income tax receipts have been steadily rising in recent years. Further, CBO and the Office of Management and Budget ("OMB") both project that revenues from corporate income taxes will continue to rise over the next 10 years. In fact, the average tax rate paid by corporations is approximately 32.5 percent and is projected by CBO to rise to 33.6 percent in 2000. In addition, according to CBO, corporate income tax receipts grew 3.5 percent for fiscal year 1998, while taxable corporate profits grew at a slower rate of only 2.3 percent. In light of the average corporate tax rate remaining relatively constant, there does not appear to be any compelling reason for a radical set of new proposals addressing "corporate tax shelters."

The Coalition also believes that, in addition to being unnecessary, the broad-based proposals could seriously undermine a corporation's ability to undertake legitimate business transactions. The vague, generalized language of the various proposals does not provide sufficient guidance to corporate taxpayers as to what transactions will constitute a "corporate tax shelter." As a result, virtually every transaction, re-

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[1] This testimony was prepared by Arthur Andersen on behalf of the Coalition for the Fair Taxation of Business Transactions.

[2] *The Economic and Budget Outlook: Fiscal Years 2000–2009*, Congressional Budget Office, January 1999

gardless of its purpose, undertaken by a corporate taxpayer that minimizes the corporation's taxes in any way will be potentially subject to the very harsh penalties contained in the tax shelter proposals.

In addition, the Coalition also believes that the broad-based corporate tax shelter proposals would unjustifiably delegate too much authority to the IRS and allow the IRS to impose harsh penalties on activities that represent legitimate business transactions. The tenor and potential effect of these broad-based proposals fly in the face of the Congressional policy underlying enactment of the IRS Restructuring and Reform Act of 1998. In particular, Congress expressed serious concerns about the excessive amount of power in the hands of IRS agents and, in response, modified the structure and operations of the IRS and expanded the rights of taxpayers against the intrusiveness of the IRS. The broad grant of authority to IRS agents in the Administration's tax shelter proposals is contrary to the theme of the IRS Restructuring and Reform Act of 1998 to curtail the power that IRS agents have over taxpayers.

Finally, the Coalition believes the level of penalties proposed by the Administration is particularly harsh in light of the overwhelming complexity of the current tax laws. The combination of the proposals would create a cascading of penalties that, both individually and in the aggregate, would be unfair and excessive. Congress has already stated that cascading penalties are unfair and expressed its disapproval of them in the IRS Restructuring and Reform Act.

In sum, Congress should reject these overly broad and unworkable proposals. The proposals transfer excessive and unnecessary authority to the IRS and unfairly impact legitimate business transactions that are not tax-motivated. Moreover, the Administration's new definition of corporate tax shelter creates additional uncertainty in a tax code that is already overwhelmed with complexity.

II. Definition of Corporate Tax Shelter

One need look no further than the proposed new definition of corporate tax shelter [3] to find the genesis of the problems with the Administration's budget proposals. Rather than providing an objective definition of a "corporate tax shelter," the proposal simply defines a corporate tax shelter as any entity, plan, or arrangement in which a corporation obtained a "tax benefit" in a "tax avoidance transaction." Under the proposal, it would no longer be necessary to find that a transaction had a "significant purpose," or indeed any purpose, to avoid taxes for the transaction to be characterized as a corporate tax shelter. As discussed below, these concepts and definitions are overly broad and vague, and are so subjective that they give virtually unlimited discretion to the IRS to determine if a transaction is a corporate tax shelter.

The proposal defines a "tax benefit" as a reduction, exclusion, avoidance or deferral of tax (or an increase in a refund) unless the benefit was "clearly contemplated" by the applicable Code provision. The proposal provides no guidance on how to determine when a tax benefit is clearly contemplated. It appears that a benefit can be an impermissible "tax benefit" even if the benefit was permitted under the actual language of the applicable Code provision. In the absence of any clear guidance, the proposal would apparently provide IRS revenue agents with the power to determine whether a taxpayer's tax benefit was a "clearly contemplated" permissible benefit. This part of the proposal simply grants too much authority to individual revenue agents, which will inevitably result in increased confrontations between taxpayers and revenue agents and a backlog of litigation in the Tax Court.

The proposal defines a "tax avoidance transaction" as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction is defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

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[3] For transactions entered into before August 6, 1997, a "tax shelter" is defined as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if the principal purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. The Taxpayer Relief Act of 1997 amended section 6662(d)(2)(C)(ii) to provide a new definition of tax shelter for purposes of the substantial understatement penalty. Under this new definition of tax shelter, the tax avoidance purpose of an entity or arrangement need not be its principal purpose. Now a tax shelter is any entity, investment, plan, or arrangement with a significant purpose of avoiding or evading Federal income taxes. The new definition of tax shelter is effective for transactions entered into after August 5, 1997.

As in the case of the definition of "tax benefit," the Administration's proposal fails to provide any guidance on what transactions would constitute "tax avoidance transactions." For example, the proposal does not provide any guidance as to the amount of expected pre-tax profit that would be insignificant relative to the reasonably expected net tax benefits. The proposal also fails to provide guidance as to how a corporate taxpayer is to accomplish the impossible task of present valuing expected net tax benefits. This inflexible, mathematical analysis does not allow for the possibility of legitimate business transactions that do not produce an easily identifiable pre-tax profit. For example, a corporation may need to structure its affairs to conform to regulatory requirements or a company may reorganize its structure to gain access to certain foreign markets. A company may also need to restructure or reorganize to gain economies of scale. In addition, a company may enter into a transaction to obtain funds for working capital at a lower cost.[4] These transactions are motivated by business concerns, even though they do not directly produce a pre-tax economic return by themselves. If these legitimate transactions are done in a tax efficient manner, they apparently will be characterized automatically as a tax shelter because they do not produce a direct economic return. Further, under the proposal, IRS agents could attempt to classify any loss transaction as a tax shelter when the transaction does not provide the expected return.

Under the second part of the proposed definition of tax avoidance transaction, any transaction that results in a significant reduction of tax on economic income could be classified as a corporate tax shelter. The proposal is silent as to what types of transactions would involve the "improper elimination" or "significant reduction" of tax on economic income. The Administration's proposal contains no restraints on the use of this provision by the IRS; therefore, the IRS can classify any legitimate business transaction as a corporate tax shelter if, in the opinion of the IRS, the transaction resulted in a significant reduction of tax on economic income. For example, the IRS could possibly classify such routine business transactions as tax-free reorganizations, tax-free spinoffs, or even check-the-box classification elections as corporate tax shelters. In other words, this proposal would allow the IRS to penalize corporate taxpayers for arranging their transactions in a tax efficient manner. This proposals ignores Judge Learned Hand's observation that:

> Anyone may so arrange his affairs that his taxes shall be as low as possible, he is not bound to chose that pattern which will best pay the Treasury, there is not even a patriotic duty to increase one's taxes.[5]

Despite Treasury's claims to the contrary, these proposed broad definitions are not simply a codification of existing judicial doctrines. Current case law views a significant pre-tax profit as a sufficient, but not a necessary, condition for finding that a transaction does not represent a corporate tax shelter. In addition, case law has always considered valid business reasons as part of the evaluation of corporate transactions. For example, the Supreme Court has upheld a transaction "which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978). Similarly, cases have held that "when a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." Knetsch v. United States, 364 U.S. 361, 366 (1960). The most recent case applying this analysis examined both the objective economics of a transaction, as well as the subjective business motivations claimed by the parties. ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998). Therefore, adopting a purely mechanical test that compares pre-tax profits to tax benefits, without looking to business reasons for the transaction, goes far beyond the holdings in current case law.

ANALYSIS OF CORPORATE TAX SHELTER PROPOSALS

A. Modified Substantial Understatement Penalty

The Administration's budget proposal would increase the substantial understatement penalty from 20 percent to 40 percent with respect to any item attributable

[4] The IRS recently issued a Technical Advice Memorandum, TAM 199910046 (November 16, 1998), in which it upheld the taxpayer's interest deduction, ruling that merely because the taxpayer did not earn a profit on the transaction did not imply that the transaction lacked economic substance.

[5] *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935).

to a corporate tax shelter.[6] A corporation can reduce the 40 percent penalty to 20 percent by fulfilling specific disclosure requirements. This proposal would also eliminate the reasonable cause exception to the imposition of the penalty for any item attributable to a corporate tax shelter.

There is no rationale for increasing the substantial understatement penalty from 20 to 40 percent. The current 20 percent penalty is a powerful incentive for corporate taxpayers to closely analyze any proposed business transaction that results in tax benefits. Moreover, Treasury has failed to provide objective evidence to establish that doubling the substantial understatement will have any incremental behavioral effect. In addition, the proposed definition of "corporate tax shelter" is too vague, and creates too much uncertainty, to justify a 40 percent penalty. Such an increase in penalties is also inconsistent with the intent of the IRS Restructuring and Reform Act to simplify penalty administration and reduce burdens on taxpayers.

Even less justified is the elimination of the reasonable cause exception to the penalty. The reasonable cause exception is an essential function of the penalty regime and is found in virtually every penalty provision of the Code. The rationale for such an exception is simple: in light of the complexity of the Code and the significant uncertainty in its interpretation, it is unfair to automatically impose a penalty upon a taxpayer who has made a good faith effort to comply with the tax law. Without such an exception, taxpayers will be faced with a draconian 40 percent penalty for a misinterpretation of the law, even if there is an honest disagreement on the interpretation of fact and law that is reasonable in light of all the facts and circumstances. In effect, taxpayers will be held to a strict liability standard in interpreting overly complex tax laws.

The elimination of the reasonable cause exception will also have a serious impact on the administration of the tax law. For example, preventing the IRS from waiving penalties for reasonable cause will result in a decline in the number of cases settled administratively. The size of the penalty and the inability on the part of the IRS to waive the penalty will require taxpayers to litigate the underlying issue of whether the transaction was a corporate tax shelter. In addition, the combination of the elimination of the reasonable cause exception and the creation of a subjective definition of corporate tax shelter will give agents an unwarranted opportunity to hold corporate taxpayers hostage during the examination process. Revenue agents can threaten to propose adjustments based on alleged corporate tax shelter transactions to extract unreasonable concessions by the corporate taxpayer on other issues. The use of the increased substantial understatement penalty to obtain concessions from corporate taxpayers is inconsistent with the goals expressed in the IRS Restructuring and Reform Act of 1998.

B. Deny Certain Tax Benefits to Persons Avoiding Income Tax as a Result of Tax Avoidance Transactions

Currently, under section 269 of the Code, the Secretary of the Treasury has the authority to disallow a tax benefit in certain acquisition transactions where the principle purpose for entering into the transaction is the evasion or avoidance of Federal income tax by obtaining the benefit of a deduction, credit, or other allowance. This provision applies to transactions involving the acquisition of control of a corporation (directly or indirectly), or to transactions where a corporation acquires (directly or indirectly) carryover basis property of another corporation that was not controlled by the acquiring corporation immediately before the transaction. The tax benefits that may be disallowed under section 269 include net operating losses, foreign tax credit carryovers, investment credit carryovers, depreciation deductions, and a wide range of other tax attributes.

The Administration's proposal would dramatically expand section 269 and give the IRS authority to disallow a deduction, credit, exclusion, or other allowance obtained in a "tax avoidance transaction."[7] Thus, the proposal goes well beyond the context of the current section 269 and would represent an inappropriate delegation of authority to Treasury and IRS personnel. Under this proposal, revenue agents could disallow any deduction, credit, exclusion, or other allowance obtained by a corporate taxpayer based on their subjective determination that a transaction falls within the vague definition of a "tax avoidance transaction." This authority could be used to deny a corporate taxpayer a tax benefit provided by the Code merely be-

[6] Generally, Section 6662(a) of the Internal Revenue Code imposes a 20 percent penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax.

[7] The definition of "tax avoidance transaction" for purpose of this transaction is the same as is used to define a corporate tax shelter, discussed above.

cause the IRS believes that the transaction yielded too much tax savings, regardless of a corporate taxpayer's legitimate business purpose for entering into the transaction. Again, this is giving an IRS agent too much discretion and is inconsistent with the IRS Restructuring and Reform Act.

C. Deny Deductions For Certain Tax Advice and Imposition of an Excise Tax on Certain Fees Received.

The Administration's proposal would deny a deduction for fees paid or incurred in connection with the purchase and implementation, as well as the rendering of tax advice related to, corporate tax shelters and impose a 25-percent excise tax on fees received in connection therewith. This proposal relies on the same vague and faulty definition of "tax avoidance transaction" as the previously discussed proposals. Thus, if in the IRS's view a transaction significantly reduces tax on economic income, or if the transaction does not meet the economic profit test, a tax deduction can be denied for tax advice that represents an ordinary and necessary business expense associated with a legitimate business transaction. An even more absurd result is that a deduction would be disallowed for fees related to tax advice where the advice is to not invest in a particular transaction because it may be considered a tax shelter.

This provision also illustrates the overlapping nature of the corporate tax shelter proposals and the potentially cascading penalties they can impose on a corporate taxpayer. For example, assume that a taxpayer entered into a legitimate business transaction on the advice of its tax adviser that the transaction was not a tax avoidance transaction. If the IRS subsequently determines that the transaction did not have sufficient pre-tax benefits, the transaction could be classified as a tax avoidance transaction. The corporate taxpayer would be subject to at least three penalties: (1) denial of the deduction for fees paid to the tax adviser for what has previously always been considered an ordinary and necessary business expense, (2) the 40 percent modified substantial understatement penalty on the disallowed deduction for the fees paid, and (3) the 40 percent modified substantial understatement penalty on the tax attributed to the tax benefits denied as a result of the IRS characterizing the transaction as a tax avoidance transaction.

Finally, this particular proposal to impose an excise tax on fees received in connection with a tax shelter raises numerous administrative issues. The determination that a transaction falls within the new definition of corporate tax shelters may not be made until years after the payment or the receipt of fees, which raises questions concerning the statute of limitations and the IRS's assessment authority against the "shelter provider." Fairness demands that the fee recipient also be provided an opportunity to challenge the tax shelter determination, which may result in the issue being litigated twice. These are only a few of the practical problems that need resolution in order to implement this vague proposal.

D. Impose Excise Tax on Certain Rescission Provisions and Provisions Guaranteeing Tax Benefits

The Administration's budget proposal would impose an excise tax on a "tax benefit protection arrangement" provided to the purchaser of a corporate tax shelter. A tax benefit protection arrangement would include a rescission clause requiring a seller or counterparty to unwind the transaction, a guarantee of tax benefits arrangement, or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction). The Administration's plan would impose on the purchaser of a corporate tax shelter an excise tax of 25% on the maximum payment to be made under a tax benefit arrangement if the tax benefits are denied.

As a practical matter, this proposal fails to consider how rescission clauses or guarantees work. Generally, these agreements put a tax adviser at risk for an agreed-upon percentage of any additional tax that the taxpayer ultimately owes as a result of the transaction. This amount cannot be determined unless and until the Service proposes adjustments to the taxpayer's liability with respect to the transaction and the taxpayer's correct tax liability is either agreed upon by the parties or determined by a court. Until such time, a corporate taxpayer cannot determine the maximum payment possible under the arrangement. Moreover, assessing an excise tax based upon the highest potential benefits that could possibly be obtained in the future under such an agreement is fundamentally unfair and is too onerous a penalty.

E. Preclude Taxpayers From Taking Tax Positions Inconsistent With the Form of Their Transaction

The Administration's budget proposal would generally provide that a corporate taxpayer is precluded from taking any position that is inconsistent with its form if a "tax indifferent party" is involved in the transaction. This rule would not apply (1) if the taxpayer discloses the inconsistent position on a timely filed original return; (2) to the extent provided in regulations, if reporting the substance of the transaction more clearly reflects income; or (3) to certain transactions (such as publicly-available securities, lending and sale-repurchase transactions) identified in regulations.

This proposal would essentially require a U.S. taxpayer to be bound by the form of a transaction unless it disclosed the inconsistent position to the IRS. Presumably, an IRS agent could then scrutinize the transaction to determine whether it would be considered a tax shelter. This would place undue authority in the hands of IRS agents to change the tax treatment of a transaction and would result in arbitrary and inconsistent application of the tax law.

For example, a foreign jurisdiction may respect a note as debt even though it would be characterized as equity for U.S. tax purposes. (A 100-year note is generally treated as equity for U.S. tax purposes; however, another country's tax laws may respect the note as debt.) As a result, payments on the note by a foreign subsidiary to its U.S. parent would be treated as deductible interest under the foreign country's tax laws. The U.S. would treat the payment as a dividend that would provide the U.S. parent with a deemed paid foreign tax credit. Because the instrument was formally labeled a note, however, the taxpayer's treatment of the note as equity for U.S. purposes would be inconsistent with the form. Assuming the parent had expiring foreign tax credits, the U.S. parent would be a tax-indifferent party under the proposal. Therefore, an agent on audit might deny the foreign tax credit generated by the dividend payment on the grounds that the taxpayer treated the note as debt for foreign tax purposes and the foreign tax benefit created a tax shelter.

This result is especially harsh for three reasons. First, the appropriate goal of U.S. tax policy should be to determine the proper character of a transaction for federal income tax purposes and then to tax the transaction in accordance with that character. A rule that allows recharacterization based upon inconsistent treatment under foreign law is at odds with this policy because two transactions that are economically indistinguishable will be treated differently. Furthermore, it violates the general principle that U.S. tax principles and not foreign principles should control. Second, the foreign country may have made a conscious policy decision to respect the note as debt. It is inappropriate to give an agent on audit the ability to penalize a taxpayer for using a benefit provided by the foreign tax law; the agent would essentially be substituting the agent's judgment for the judgment of the foreign country's lawmakers. Third, this provision interferes with the consistent application of U.S. tax law because an agent on audit would have tremendous discretion to choose not to follow normal tax principles. The determination of the tax treatment of a transaction would be made by individual agents, not by Congress or by Treasury in its regulatory capacity.

F. Tax Income From Corporate Tax Shelters Including Tax-Indifferent Parties.

The Administration's budget plan would impose a tax on corporate tax shelter transactions involving "tax-indifferent" parties. A "tax-indifferent" party is defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with expiring loss or credit carryforwards (generally more than 3 years old). The transactions targeted by this proposal generally result in the tax-indifferent parties having income or gain from the transaction, while taxable corporate participants may have deductions or loss from the transaction. The proposal would impose tax on the tax-indifferent party by recharacterizing the item of gain or income as taxable. For example, a foreign person would be treated as earning taxable effectively connected income; a tax-exempt organization would be treated as earning unrelated business taxable income. All other participants in the corporate tax shelter would be jointly and severally liable for the tax.

As with the other corporate tax shelter provisions, the broad definition of corporate tax shelter does not provide sufficient specificity for taxpayers or tax-indifferent parties to determine what transactions might run afoul of these rules. The vague and subjective definition creates an environment of uncertainty for such parties when making business and investment decisions, and it is likely that many routine business arrangements would fall within this broad definition.

The proposal also raises treaty issues because it would provide that tax on income or gain allocable to a foreign person would be determined without regard to applicable treaties. Even though the other parties to a transaction might bear the ultimate liability for the tax under this proposal, the proposal would in essence impose a U.S. tax burden on a transaction that should be exempt from U.S. tax under the treaty, thus changing the economics of the transaction. The imposition of tax on a transaction that should be exempt under a treaty could raise concerns from treaty partners.

IV. Current Legislative And Regulatory "Tax Shelter" Provisions

As discussed above, the Administration's broad-based proposals would grant the IRS unfettered authority to determine what is a corporate tax shelter and to subject these transactions to harsh and cascading penalties. We are concerned with Treasury's request for this broad authority when they have not even tried to use some of the tools that Congress has granted within the last few years. A better approach to any perceived problem would be for Treasury to use the tools currently within its arsenal, along with specific legislative or regulatory actions targeted at closing perceived loopholes. The broad scope of such current alternatives is illustrated below.

A. Substantial Understatement Penalty

Current law imposes a 20 percent penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax. For corporations, a substantial understatement of income tax exists if it exceeds the greater of 10 percent of the tax required to be shown on the tax return or $10,000.[8] If a corporation has a substantial understatement of income tax attributable to a tax shelter item, a corporation is liable for the substantial understatement penalty unless it can demonstrate reasonable cause.

As discussed above, Congress expanded the definition of tax shelter for purposes of the substantial understatement penalty in the Taxpayer Relief Act of 1997. Under this expanded definition, a transaction may be a tax shelter if *a* significant purpose of the transaction was to avoid taxes. (Under the prior provision, a transaction was a tax shelter only if *the* principal purpose of the transaction was to avoid taxes). This significant expansion of the definition of tax shelter has been in the law for less than two years, and there has not been sufficient time to determine whether this new definition is effective. Before enacting a plethora of new penalties and granting revenue agents larger and more potent weapons, the expanded definition in current law should be given a chance to work.

B. Tax Shelter Registration

The 1997 Act added section 6111(d), which treats certain confidential arrangements as tax shelters that must be registered with the IRS. For purposes of this provision, a "tax shelter" includes any entity, plan, arrangement, or transaction: (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant; (2) that is offered to any potential participant under conditions of confidentiality; and (3) for which promoters may receive fees in excess of $100,000 in the aggregate. An offer is considered to be made under conditions of confidentiality if: (1) the potential participant has an understanding or agreement with or for the benefit of any promoter that restricts or limits the disclosure of the transaction or any significant tax benefits; or (2) any promoter of the tax shelter claims, knows, or has reason to know that the transaction is proprietary to the promoter or any other person other than the potential participant, or is otherwise protected from disclosure or use by others.[9] The penalty for failing to timely register a corporate tax shelter can be severe: the greater of $10,000 or 50 percent of the fees paid to all promoters from offerings prior to the date of registration. If the failure to file is intentional, the penalty is increased to 75 percent of the fees.[10]

This registration requirement was intended to provide Treasury and the IRS with useful information about corporate transactions as early as possible, enabling them to more easily identify these transactions. In addition, this information enables Treasury to make determinations with respect to when administrative or legislative action may be necessary. The committee report explained the need for this corporate tax shelter registration requirement:

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[8] The Administration has also proposed to treat a corporation's understatement of more than 10 million dollars of income tax as substantial for purposes of the substantial understatement penalty, whether or not it exceeds 10 percent of the taxpayer's total tax liability.

[9] Section 6111(d)(2).

[10] Section 6707

> The provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.[11]

These tax shelter registration provisions apply to any tax shelter offered to potential participants after the date that the Treasury Department issues guidance on registration. As of this date, no guidance has been issued and, therefore, this registration provision is not yet effective. It is premature to propose a new and complex set of measures to deal with a perceived increase in corporate tax shelter activity when powerful provisions have already been enacted, but Treasury has not, almost two years after enactment, implemented them. Rather than enact a number of vague and subjective provisions as proposed, the more prudent course would be to issue the required guidance so that the registration requirements become effective, then evaluate the registration provisions to determine whether they produce the desired result.

C. Anti-Abuse Rules

Treasury and the IRS have a wide range of general anti-abuse provisions already available to combat the perceived proliferation of corporate tax shelters. For example, if a taxpayer's method of accounting does not clearly reflect income, section 446(b) of the Code authorizes the IRS to disregard the taxpayer's method of accounting and to compute the taxpayer's income under a method of accounting it believes more clearly reflects income. Under section 482 of the Code, the IRS can allocate, distribute, or apportion income, deductions, credits and allowances between controlled taxpayers to prevent evasion of taxes or to accurately reflect their taxable income.

Treasury has promulgated Treas. Reg. δ 1.701–2 as a broad anti-abuse rule that permits the IRS to stop perceived abuses with respect to partnerships. Under this anti-abuse regulation, the IRS already has the ability to disregard the existence of a partnership, adjust a partnership's method of accounting, reallocate items of income, gain, loss, deduction or credit, or adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the partnership tax rules.

The IRS also has broad authority to stop abuses in the corporate context. For example, the IRS can recharacterize certain stock sales by shareholders as dividends when the purchaser is the issuing corporation or a related corporation under section 302(d) or section 304. Section 338(e)(3) authorizes the IRS to treat certain stock acquisitions as qualified stock purchases in order to prevent avoidance of the requirements of section 338. Section 355(d)(9) gives the IRS the regulatory authority to prevent the avoidance of certain gain recognition requirements under section 355 through the use of related persons, intermediaries, pass-through entities or other arrangements.

D. Case Law

There is a well-established body of case law addressing tax shelters. The principles developed in these cases include the "sham transaction" doctrine, the "business purpose" doctrine, and the "economic substance" doctrine. In applying these principles, the IRS may assert that a transaction should not be respected for tax purposes because it did not have a substantive purpose beyond securing tax benefits. See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. United States, 364 U.S. 361 (1960); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Sheldon v. Commissioner, 94 T.C. 738 (1990). These principles have been in existence for many years, and they have not lost their utility. They represent a set of standards that can be applied no matter how sophisticated a transaction might be. Most recently, the IRS successfully litigated two cases in this area, ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g, rev'g in part and remanding, 73 TCM 2189 (1997), cert. denied, S. Ct. Dkt. No. 98–1106 and ASA Investerings v. Commissioner, 76 TCM 325 (1998).

E. IRS Announcements

The IRS has the authority to issue administrative pronouncements to address perceived abusive transactions. These pronouncements may take the form of notices,

[11] H.R. Rep. No. 105–148, 105th Cong., 1st Sess. 429.

rulings, or other announcements. In the past few years, the IRS has not hesitated to take advantage of this authority. For example, Notice 97–21 effectively shut down "step-down preferred" transactions. More recently, in fact within the past few days, the IRS has attacked certain types of "lease-in lease-out" transactions that it perceived to be abusive through the issuance of Rev. Rul. 99–14. The number of announcements the IRS has issued in the past few years addressing perceived tax shelter activity has been substantial: Notice 98–11 (attacking "hybrid branch arrangements"); Notice 98–5 (attacking transactions that generate foreign tax credits); Notice 96–39 (setting forth the IRS' position on determining whether income from a partnership represented Subpart F income); Notice 95–53 (attacking lease stripping transactions); Notice 94–48 (scrutinizing tax-deductible passthrough debt to buy back stock, or "reverse MIPs"); Notice 94–47 (scrutinizing tax-deductible preferred instruments, or "MIPS"); Notice 94–93 (attacking "corporate inversion" transactions); Notice 94–46 (attacking outbound "corporate inversion transactions").

Note that as part of the IRS Restructuring and Reform Act, Congress expressed its concern and disagreement with the policy direction of Notice 98–11, as well as their interest in reviewing these issues and taking legislative action they deemed to be appropriate. This controversy demonstrates the need for determinations of what constitutes an abusive transaction to be made in a public manner, through issuance of legislation or an administrative pronouncement, rather than being made by individual IRS agents.

F. Legislation Targeted to Specific Transactions

Another important alternative to the broad-based Administration proposals is specific, targeted statutory changes. Each year Treasury transmits to Congress its suggestions for changes to the tax laws, including targeted proposals to stop abuses and, as a matter of course, Congress has asserted its legislative powers to clarify and amend statutes that are unclear or allow for abuse. On a number of occasions, the Congressional tax writing committees have enacted targeted statutory changes to end specific tax shelter or abusive activity, often with the assistance and consultation of the Treasury Department. For example, in 1998 and 1997 alone, Congress pursued and enacted a number of targeted proposals, including:

- Modification of certain deductible liquidating distributions of regulated investment companies (RIC) and real estate investment trusts (REIT);
- Restrictions on 10-year net operating loss carryback rules for specified liability losses;
- Requirement of gain recognition on certain appreciated financial positions in personal property;
- Election of mark-to-market for securities traders and for traders and dealers in commodities;
- Limitation on the exception for investment companies under section 351;
- Determination of original issue discount where pooled debt obligations are subject to acceleration;
- Denial of interest deduction for on certain convertible preferred stock;
- Requirement of gain recognition for certain extraordinary dividends;
- Anti-Morris Trust provisions;
- Reform of the tax treatment of certain corporate stock transfers;
- Treatment of certain preferred stock as boot;
- Modification of holding period for the dividends-received deduction;
- Inclusion of income from notional principal contracts and stock lending transactions under Subpart F;
- Restriction on like-kind exchanges involving foreign personal property;
- Imposition of holding period requirement for claiming foreign tax credits with respect to dividends;
- Allocation of basis of properties distributed to a partner by a partnership;
- Elimination of the substantial appreciation requirement for inventory on sale of partnership interest; and
- Modification of treatment of company-owned life insurance.

These proposals, which raise nearly $20 billion in tax revenue over 10 years, were targeted at clarifying the statute and/or stopping abuses of the tax law and have been effective in ending certain tax shelter activity. While we believe that many of these items are not abuses, this incomplete list demonstrates that if a statutory provision allows for broader application than Congress may have intended, Congress and the Treasury can statutorily shut them down. Treasury is now essentially asking Congress to short-circuit this well-established legislative approach and provide the IRS with broad authority to characterize a wide range of transaction as "tax shelters" without the need for Congressional oversight or approval.

CONCLUSION

The Administration's "corporate tax shelter" proposals go far beyond simply closing unwarranted loopholes: the proposals would have a detrimental impact on legitimate business transactions and could result in the imposition of draconian penalties on taxpayers. The unfettered power transferred to IRS agents would shift the formulation of tax policy from Congress to the tax collector by giving IRS agents unprecedented latitude to reclassify transactions as corporate tax shelters. Congress, not the tax administrator, should make these tax policy decisions.

Statement of Coalition of Mortgage REITs

The following comments are offered by a group of mortgage real estate investment trusts (hereinafter referred to as the "Coalition") to the Committee on Ways and Means in conjunction with its March 10 hearing on the revenue-raising provisions of the Clinton Administration's FY 2000 budget plan. Coalition members include IndyMac Mortgage Holdings, Inc., Dynex Capital, Inc., IMPAC Mortgage Holdings, Inc., IMPAC Commercial Holdings, Inc., Redwood Trust, Inc., and Capstead Mortgage Holdings. These comments focus on the Administration's proposal to modify the structure of businesses indirectly conducted by real estate investment trusts ("REITs").

IndyMac Mortgage Holdings, Inc., based in Pasadena, California, is the largest publicly traded mortgage REIT[1] in terms of stock market capitalization, and its structure and business activities make it a useful reference point in discussing the impact of the Administration's proposal. IndyMac is a diversified lending company with a focus on residential mortgage products, and is active in residential and commercial construction lending, manufactured housing lending, and home improvement lending. IndyMac is a NYSE-traded company with $6 billion in assets and nearly 1,000 employees. IndyMac Mortgage Holdings participates in the mortgage conduit and securitization business through an affiliated taxable operating company, IndyMac, Inc.

The Coalition has specific concerns over the Administration's proposal to modify the structure of businesses indirectly conducted by REITs. As a result of these concerns, the Coalition's support for this proposal would be contingent on critical modifications being made. Without these modifications, IndyMac and other REITs would be unable to continue to participate in the mortgage conduit or securitization business. The changes requested by the Coalition would be consistent with the Administration's goal not to impede the competitiveness of REITs, while at the same time addressing—more than adequately, we believe—the concerns of the Treasury Department over any potential for tax avoidance by mortgage REITs.

THE MORTGAGE CONDUIT BUSINESS

As one of its most important business activities, IndyMac operates as one of only a small number of private mortgage conduits in this country. While small in number, mortgage conduits play a vital financing role in America's residential housing market, essentially acting as the intermediary between the originator of a mortgage loan and the ultimate investor in mortgage-backed securities (MBSs).

The conduit first purchases mortgage loans made by financial institutions, mortgage bankers, mortgage brokers, and other mortgage originators to homebuyers and others. When a conduit has acquired sufficient individual loans to serve as collateral for a loan pool, it creates an MBS or a series of MBSs, which then are sold to investors through underwriters and investment bankers. After securitization, the conduit acts as a servicer of the loans held as collateral for the MBSs, meaning that the conduit collects the principal and interest payments on the underlying mortgage loans and remits them to the trustee for the MBS holders.

Perhaps the best-known mortgage conduits are the government-owned Government National Mortgage Association (Ginnie Mae) and the government-sponsored Fannie Mae and Freddie Mac. These government sponsored enterprises (GSEs) act as conduits for loans meeting specified guidelines that pertain to loan amount, product type, and underwriting standards, known as "conforming" mortgage loans.

[1] A mortgage REIT invests primarily in debt secured by mortgages on real estate assets. An equity REIT, by contrast, invests primarily in equity or ownership interests directly in real estate assets.

Private conduits such as IndyMac play a similar role for "nonconforming" mortgage loans that do not meet GSE selection criteria. Mortgage loans purchased by IndyMac include "Alt-A," nonconforming and jumbo residential loans, sub-prime loans, consumer construction loans, manufacturing housing loans, home improvement loans, and other mortgage-related assets. Many of IndyMac's borrowers are low-income and minority consumers who are not eligible for programs currently offered by the GSEs or Ginnie Mae. In sum, IndyMac, through its conduit activities, has helped to fill a significant void in the residential mortgage and mortgage investment industry that the GSEs have been unable to fill.

INDYMAC'S BUSINESS STRUCTURE

IndyMac's mortgage conduit business is conducted primarily through two entities: IndyMac Mortgage Holdings, Inc., which as discussed above is a REIT (hereafter referred to as "IndyMac REIT"), and its taxable affiliate, IndyMac, Inc. (hereafter referred to as "IndyMac Operating"). IndyMac REIT owns all of the preferred stock and 99 percent of the economic interest in IndyMac Operating, which is a taxable C corporation.

IndyMac REIT is the arm of the conduit business that purchases and holds mortgage loans. IndyMac Operating is the arm of IndyMac REIT that acquires loans for IndyMac REIT, pursuant to a contractual sales commitment, and securitizes and services the loans. In order to control the interest rate risks associated with managing a pipeline of loans held for sale, IndyMac Operating also conducts necessary hedging activities. In addition, IndyMac Operating performs servicing for all loans and MBSs owned or issued by it. IndyMac Operating is liable for corporate income taxes on its net income, which is derived primarily from gains on the sale of mortgage loans and MBSs as well as servicing fee income.

Use of this "preferred stock" structure for conducting business is, in part, an outgrowth of the tax laws governing REITs. IndyMac REIT, by itself, effectively is unable to securitize its loans through the most efficient capital markets structure, called a real estate mortgage investment conduit ("REMIC"). This is because the issuance of REMICs by a REIT in effect would be treated as a sale for tax purposes; such treatment in turn would expose the REIT to a 100-percent prohibited tax on "dealer activity." Similarly, it is well understood that the ability to service a loan is critical to owning a loan, and IndyMac REIT would be subject to strict and unworkable limits on engaging in mortgage servicing activities for third parties. Such activities would generate nonqualifying fee income under the 95-percent REIT gross income test,[2] potentially disqualifying IndyMac REIT from its status as a REIT. It is critical to keep in mind that all net income derived by IndyMac Operating from its business activities is subject to two tiers of taxation at state and federal levels.

In business terms, IndyMac's use of the preferred stock structure aligns its "core competencies," which has allowed it to compete in the mortgage banking and conduit business. This alignment makes available the benefits of centralized management, lower costs, and operating efficiencies, and has allowed IndyMac to respond to market changes, such as trends toward securitization, all to the benefit of homeowners who do not fit within traditional GSE lending criteria.

ADMINISTRATION PROPOSAL

The proposal in the Administration's FY 2000 budget would prohibit use of the REIT preferred stock subsidiary structure. Specifically, the proposal would amend section 856(c)(5)(B) of the Internal Revenue Code to prohibit REITs from holding stock possessing more than 10 percent of the

vote or value of all classes of stock of a corporation. This proposal has arisen out of a concern on the part of Treasury that income earned by preferred stock subsidiaries escapes corporate tax as a result of "transmuting of operating income into interest paid to the REIT and other non-arm's length pricing arrangements."[3]

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[2] The 95-percent test generally limits REITS to receiving income that qualifies as rents from real property and portfolio income.

[3] *General Explanations of the Administration's Revenue Proposals*, Department of the Treasury, February 1999, p. 140. IndyMac believes Treasury's income-shifting argument is significantly overstated. The REIT rules strictly regulate the types and amount of income that may be earned by a REIT. IndyMac REIT and others in the REIT industry are strongly discouraged from taking aggressive tax positions, given the severity of potential tax penalties, including loss of REIT status and the 100-percent prohibited transactions tax.

At the same time, Treasury recognizes that many activities conducted by REIT preferred stock subsidiaries represent legitimate business activities that should continue to be available to REIT investors:[4]

> Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

In light of these concerns, the Administration proposal would allow a REIT to establish a "taxable REIT subsidiary" ("TRS") to perform certain activities that cannot be conducted directly by a REIT. These TRSs would be subject to a number of restrictions, including a provision that a TRS could not deduct any interest incurred on debt funded directly or indirectly by the REIT. Other restrictions would place limits on the value of TRSs that could be owned by REITs; impose an excise tax on any excess payments made by the TRS to the REIT; and limit intercompany rentals between the REIT and the TRS.[5]

It is not clear that the Treasury proposal ever contemplates mortgage REIT preferred stock subsidiaries like IndyMac Operating.[6] If not, the inability of mortgage REITs to utilize the "taxable REIT subsidiary" structure would have a severe negative impact on IndyMac and the housing industry. If mortgage REITs are intended to be permitted to establish TRSs, it is still the case that the Administration's current proposal contains unworkable restrictions that effectively would end the synergies between mortgage REITs and taxable entities that have so benefited homeowners and the housing industry.

In allowing REITs to conduct otherwise disqualifying business activities through taxable subsidiaries, the Administration's FY 2000 budget proposal represents a significant improvement over a similar proposal included in last year's Administration budget submission. Like the current proposal, last year's proposal would have prohibited use of the REIT preferred stock subsidiary structure. However, last year's proposal, rather than allowing REITs to convert preferred stock subsidiaries into a taxable subsidiary, would have "grandfathered" existing preferred stock structures, but under an overly restrictive set of rules that was viewed as unworkable by industry.

IMPACT ON MORTGAGE REITS

If the Administration's FY 2000 budget proposal were enacted, IndyMac REIT would be forced to end its preferred stock affiliation with IndyMac Operating. In order to continue in the mortgage conduit business, IndyMac REIT and other mortgage REITs would have to consider converting their affiliates into a TRS under the terms outlined by the Administration in its proposal, assuming that the Administration's proposal contemplates this provision applying to mortgage REIT subsidiaries.

At least in concept, IndyMac would be willing to entertain a conversion of IndyMac Operating from a preferred stock affiliate into a taxable subsidiary. As discussed above, IndyMac Operating does not engage in the type of income shifting activities that have prompted Treasury's concerns.

However, certain restrictions proposed by the Treasury Department with respect to the operation of the TRS would be completely unworkable for IndyMac and other mortgage REITs. Most significant, by far, is the Administration's proposed disallowance of interest deductions on debt funded directly or indirectly by the REIT.

This proposed restriction overlooks the fundamental element of debt in the day-to-day business operations of finance companies, like mortgage conduits. IndyMac Operating borrows extensively to finance its operations, such as the purchase of mortgages. These loans can come from outside third parties, such as banks or investment banks, with the sponsoring REIT as effective guarantor, or from loans directly from the sponsoring REIT.

Direct loans from the sponsoring REIT clearly would be impacted by the Administration's proposal, and it is possible that guaranteed loans would also be covered as "indirect" loans. To the extent that any or all of these types of loans are considered

[4] *Id*, at 140.

[5] The proposal would allow REITs to convert preferred stock subsidiaries into TRSs on a tax-free basis within a window period, as yet unspecified.

[6] For example, the Treasury explanation of the proposal discusses activities of a TRS by reference to "tenant" and "non-tenant" activities.

direct or indirect loans subject to the interest expense disallowance, the inability to deduct a finance company's core and largest business expense would make it impossible for IndyMac Operating to compete with all other finance companies which are entitled to deduct such expenses. This exposure would be sufficient to force an end to IndyMac Operating's ability to conduct its business activities in conjunction with IndyMac REIT, thus divorcing the two critical elements of IndyMac's mortgage conduit business. If IndyMac and the other mortgage REITs were unable to conduct their business, it would have a severe impact on the housing market, because IndyMac and other mortgage REITs provide a vital link between investors and borrowers in the non-conforming and jumbo markets who are not served by the GSEs.

The taxable preferred stock subsidiaries of IndyMac and other mortgage REITs operate in the same manner as a finance company that makes loans and securitizes or sells them to investors. All finance companies that are not depository institutions require external debt to fund loan originations. All operate at relatively high leverage because loan assets typically are saleable and thus relatively liquid.

Through their affiliation with a REIT, these taxable preferred stock subsidiaries are able to access capital to fund operations at lower rates than would be the case if they tried to access public debt markets directly. Compared to the taxable entity, the REIT is generally better capitalized and larger, in terms of assets and borrowings, and thus can borrow at lower rates than the preferred stock subsidiary. Lenders generally lend to the REIT and the taxable entity on a combined basis, and require credit support from the larger entity.

Without credit support, the taxable subsidiaries would have higher borrowing costs, which ultimately would be passed on to borrowers served through the mortgage conduit businesses operated by IndyMac and others as higher interest rates and costs.[7] The proposal would operate, therefore, like a tax on these homeowner/borrowers. There is no reason to impose this tax—there are specific rules already in the Code that could be adopted to prevent the potential for tax abuse that has given rise to the Administration's proposal. These rules are described in the following section.

NECESSARY MODIFICATIONS

The Administration's proposed interest deduction disallowance is intended to prevent excessive interest charges by a sponsoring REIT to its taxable subsidiary, or TRS. As opposed to the TRS interest expense disallowance proposed by the Treasury Department, the Coalition strongly believes that the "earnings stripping" limitations imposed under section 163(j) of the Internal Revenue Code for interest paid to or accrued by tax-exempt entities and foreign persons would adequately, and more fairly, prevent any perceived abuses resulting from direct or indirect lending between a REIT and a TRS. At the same time, adoption of this rule would preserve the TRS's ability to conduct its business and serve its customers.

Enacted in 1989, section 163(j) was crafted specifically to prevent the siphoning of earnings from a corporation by a related person that is exempt from U.S. tax, e.g., a foreign company. Those rules extend both to direct lending activities as well as to guarantees by a related person of loans obtained by the corporation from unrelated persons. Under these rules, a corporation's interest deductions for a taxable year may be denied if the corporation has excess interest expense for a year *and* its ratio of debt to equity exceeds 1.5 to 1.

Substitution of this earnings stripping rule for the complete interest deduction disallowance under the Administration's proposal would guard against true abuse while accommodating legitimate mortgage conduit business activities. The purpose of section 163(j) was to limit interest deductions for leveraged companies that generate a *negative* spread in view of the likelihood that the negative spread was attributable to earnings stripping. In contrast, the companies affiliated with IndyMac and other mortgage REITs in the mortgage conduit business generally generate excess interest income—i.e., they generate a *positive* spread on interest income. IndyMac Operating has never incurred negative spread in its six years of operation. In fact, IndyMac's taxable affiliate has incurred tax liability for positive spread it has earned in each year since its founding in 1993.

It is a fundamental fact in the finance industry that companies operating in the mortgage banking and conduit business, like IndyMac Operating, operate at relatively high leverage ratios. The same is true for GSEs like Ginnie Mae and Fannie Mae, as it is for Merrill Lynch, Bank of America, and other well-known industry

[7] These higher borrowing costs would translate into increased deductible interest expenses for the taxable subsidiaries, which would reduce the amount of revenues that would be collected as a result of the proposal.

names. The presence of this debt is inherent in the business of a finance company and is not, in and of itself, any indication of a situation where earnings are being stripped. In enacting the rules under section 163(j), Congress made clear that an earnings stripping situation involves the combination of high leverage *and* a negative interest spread. The Coalition agrees.

In sum, the Coalition believes that adoption of the section 163(j) rules would allow IndyMac and other mortgage REITs to continue to participate in the mortgage conduit business and provide financing to segments of the housing industry not currently served by the GSEs. At the same time, we believe the section 163(j) rules would guard effectively against true earnings stripping situations. It would be unreasonable to subject REITs and their affiliates to the Administration's complete disallowance of interest deductions, a rule that would be more stringent than those currently applied with respect to transactions between U.S. and related foreign companies.

CONCLUSION

Congress enacted the REIT rules in 1960 to give small investors the same access to dynamic real estate markets that are available to larger investors. Working with the National Association of Real Estate Investment Trusts ("NAREIT"), Congress has amended the REIT statute many times since to respond to dramatic changes in the real estate industry. The Administration's proposal to modify the structure of businesses that may be conducted indirectly by REITs may be viewed, and commended, as a further effort to modernize the REIT rules.

However, as discussed above, the Administration proposal must be modified to address the concerns of an important sector of the REIT industry, namely mortgage REITs. Specifically, the proposed restrictions on the operation of the taxable REIT subsidiaries under the Administration's proposal would fundamentally impede the business practices of REITs like IndyMac involved in the mortgage conduit business. The proposed outright elimination of deductions for interest on intercompany debt or REIT-guaranteed debt would lead IndyMac and other mortgage REITs to sever themselves from the core competencies of servicing and securitizing mortgage loans. Thus, IndyMac's individual investors no longer would be able to participate effectively in the mortgage conduit business, contrary to Congressional intent to give these REIT investors access to the real estate mortgage markets.

If the Administration's proposal is to receive serious consideration, it will be paramount to replace the proposed wholesale interest deduction disallowance with the earnings stripping rules under section 163(j). The Coalition also believes that the intended applicability of the TRS provisions to mortgage REITs should be made explicit. In addition, we believe it will be necessary to apply these rules over an appropriate transitional period. The Coalition is prepared to work with Congress, the Treasury, and NAREIT to develop solutions in this regard.

Statement of Coalition of Service Industries [1]

The Coalition of Service Industries, which represents a broad range of financial institutions, including both large and small institutions, strongly opposes the Administration's proposal to increase penalties for failure to file correct information returns.

The proposed penalties are unwarranted and place an undue burden on already compliant taxpayers. It seems clear that most, if not all, of the revenue estimated to be raised from this proposal would stem from the imposition of higher penalties due to inadvertent errors rather than from enhanced compliance. The financial services community devotes an extraordinary amount of resources to comply with current information reporting and withholding rules and is not compensated by the U.S. government for these resources. The proposed penalties are particularly inappropriate in that (i) there is no evidence of significant current non-compliance and (ii) the proposed penalties would be imposed upon financial institutions while such

[1] The Coalition of Service Industries (CSI) was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for US service companies; and encourage US leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of US service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.

institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information.

THE PROPOSAL

As included in the President's fiscal year 2000 budget, the proposal generally would increase the penalty for failure to file correct information returns on or before August 1 following the prescribed filing date from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported.[2] The increased penalties would not apply if the aggregate amount that is timely and correctly reported for a calendar year is at least 97 percent of the aggregate amount required to be reported for the calendar year. If the safe harbor applies, the present-law penalty of $50 for each return would continue to apply.

CURRENT PENALTIES ARE SUFFICIENT

We believe the current penalty regime already provides ample incentives for filers to comply with information reporting requirements. In addition to penalties for inadvertent errors or omissions,[3] severe sanctions are imposed for intentional reporting failures. In general, the current penalty structure is as follows:

- The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.
- Significantly higher penalties—generally 20 percent of the amount required to be reported (for information returns and payee statements), with no penalty caps—may be assessed in cases of intentional disregard.[4]
- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place.[5] It seems, therefore, that most of the revenue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

PENALTIES SHOULD NOT BE IMPOSED TO RAISE REVENUE

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as raising of revenue."[6] Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act of 1989.[7] There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

SAFE HARBOR NOT SUFFICIENT

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor" is not sufficient to ensure that the higher proposed penalties apply only to rel-

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[2] A similar proposal was included in President Clinton's fiscal year 1997, 1998 and 1999 budgets.

[3] It is important to note that many of these errors occur as a result of incorrect information provided by the return recipients such as incorrect taxpayer identification numbers (TINs).

[4] The standard penalty for failing to file correct information returns is $50 per failure, subject to a $250,000 cap. Where a failure is due to intentional disregard, the penalty is the greater of $100 or 10 percent of the amount required to be reported, with no cap on the amount of the penalty.

[5] Also note that, in addition to the domestic and foreign information reporting and penalty regimes that are currently in place, for payments to foreign persons, an expanded reporting regime with the concomitant penalties is effective for payments made after December 31, 1999. See TD 8734, published in the Federal Register on October 14, 1997. The payor community is being required to dedicate extensive manpower and monetary resources to put these new requirements into practice. Accordingly, these already compliant and overburdened taxpayers should not have to contend with new punitive and unnecessary penalties.

[6] Statement of former IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989, page 5).

[7] OBRA 1989 Conference Report at page 661.

atively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products, as well as new information reporting requirements,[8] are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

Application of Penalty Cap to Each Payor Entity Inequitable

We view the proposal as unduly harsh and unnecessary. The current-law $250,000 penalty cap for information returns is intended to protect the filing community from excessive penalties. However, while the $250,000 cap would continue to apply under the proposal, a filer would reach the penalty cap much faster than under current law. For institutions that file information returns for many different payor entities, the protection offered by the proposed penalty cap is substantially limited, as the $250,000 cap applies separately to each payor.

In situations involving affiliated companies, multiple nominees and families of mutual funds, the protection afforded by the penalty cap is largely illusory because it applies separately to each legal entity. At the very least, any further consideration of the proposal should apply the penalty cap provisions on an aggregate basis. The following examples illustrate why aggregation in the application of the penalty cap provisions is critical.

EXAMPLE I—Paying Agents

A bank may act as paying agent for numerous issuers of stocks and bonds. In this capacity, a bank may file information returns as the issuers' agent but the issuers, and not the bank, generally are identified as the payors. Banks may use a limited number of information reporting systems (frequently just one overall system) to generate information returns on behalf of various issuers. If an error in programming the information reporting system causes erroneous amounts to be reported, potentially all of the information returns subsequently generated by that system could be affected. Thus, a single error could, under the proposal, subject each issuer for whom the bank filed information returns, to information reporting penalties because the penalties would be assessed on a taxpayer-by-taxpayer basis. In this instance, the penalty would be imposed on each issuer. However, the bank as paying agent may be required to indemnify the issuers for resulting penalties.

Recommendation: For the purposes of applying the penalty cap, the paying agent (not the issuer) should be treated as the payor.

EXAMPLE II—Retirement Plans

ABC Corporation, which services retirement plans, approaches the February 28th deadline for filing with the Internal Revenue Service the appropriate information returns (i.e., Forms 1099–R). ABC Corporation services 500 retirement plans and each plan must file over 1,000 Forms 1099–R. A systems operator, unaware of the penalties for filing late Forms 1099, attempts to contact the internal Corporate Tax Department to inform them that an extension of time to file is necessary to complete the preparation and filing of the magnetic media for the retirement plans. The systems operator is unable to reach the Corporate Tax Department by the February 28th filing deadline and files the information returns the following week. This failure, under the proposal, could lead to substantial late filing penalties for each retirement plan that ABC Corporation services (in this example, up to $75,000 for each plan).[9]

Recommendation: Retirement plan servicers (not each retirement plan) should be treated as the payor for purposes of applying the penalty cap.

EXAMPLE III—Related Companies

A bank or broker dealer generally is a member of an affiliated group of companies, which offer different products and services. Each company that is a member of the group is treated as a separate payor for information reporting and penalty purposes. Information returns for all or most of the members of the group may be generated from a single information reporting system. One error (e.g., a systems programming error) could cause information returns generated from the system to contain errors on all subsequent information returns generated by the system.

[8] For example, Form 1099–C, discharge of indebtedness reporting, or Form 1042–S, reporting for bank deposit interest paid to certain Canadian residents.

[9] If the corrected returns were filed after August 1, the penalties would be capped at $250,000 per plan.

Under the proposal, the penalty cap would apply to each affiliated company for which the system(s) produces information returns.

Recommendation: Each affiliated group [10] should be treated as a single payor for purposes of applying the penalty cap.

While these examples highlight the need to apply the type of penalty proposed by the Treasury on an aggregated basis, they also illustrate the indiscriminate and unnecessary nature of the proposal.

CONCLUSION

The Coalition of Service Industries represents the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties. In addition to this testimony, we sent a letter to Secretary of the Treasury Robert Rubin, signed by some of our member associations, voicing our opposition to the proposal. A copy of the letter is attached.

Congress has considered and rejected this proposal on three previous occasions, and we hope it will continue to reject this unwarranted penalty increase. Thank you for your consideration of our views.

[An attachment is being retained in the Committee files.]

Statement of Coalition of Service Industries [1]

INTRODUCTION

The Administration's Budget Proposal for fiscal year 2000 (the "FY2000 Budget") provides for the extension of six expiring provisions, but fails to extend the active financing exception to subpart F.[2] The active financing exception to subpart F should be extended at the same time as other provisions that will expire during calendar year 1999. Moreover, at a time when the Administration and the Congressional Budget Office are predicting "on budget" surpluses in the near term, CSI, on behalf of the undersigned industry groups, believes that the active financing exception to subpart F should be made a permanent provision in the law.

BACKGROUND

When subpart F was first enacted in 1962, the original intent was to require current U.S. taxation of foreign income of US multinational corporations that was passive in nature. The 1962 law was careful not to subject active financial services business income to current taxation through a series of detailed carve-outs. In particular, dividends, interest and certain gains derived in the active conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves were specifically excluded from current taxation if such income was earned from activities with unrelated parties. In 1986, the provisions that were put in place to ensure that a controlled foreign corporation's (CFC) active financial services business income would not be subject to current tax were repealed in response to concerns about the potential for taxpayers to route passive or mobile income through tax havens. In 1997,[3] the 1986 rules were revisited, and an exception to the subpart F rules was added for the active income of US based financial services companies, along with rules to address concerns that the provision would be available to passive operations. The active fi-

[10] A definition of "affiliated group" which may be used for this purpose may be found in Section 267(f) or, alternatively, Section 1563(a).

[1] The Coalition of Service Industries (CSI) was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for US service companies; and encourage US leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of US service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.

[2] "Subpart F" refers to the regime prescribed by Sections 951–964 of the Internal Revenue Code of 1986, as amended (the "Code"); except as noted, all references to "sections" hereinafter are to the Code.

[3] Taxpayer Relief Act of 1997, Conference Report to H.R. 2014, H. Rept. 105–220, pages 639–645.

nancing income provision was revisited in 1998, in the context of extending the provision for the 1999 tax year, and considerable changes were made to focus the provision on active financial services businesses that perform significant operations in their home country.

A comparison of current U.S. law with the laws of foreign countries shows that the United States imposes significantly stricter standards on CFCs of U.S.-based financial services companies in order for them to qualify as active financing income. For example, German law merely requires that income be earned by a bank with a commercially viable office established in the CFC's jurisdiction. Germany does not require that the CFC conduct the activities generating the income or that the income come from transactions with customers solely in the CFC's country of incorporation. The United Kingdom has an even less restrictive regime than Germany. These countries do not impose current taxation on CFC income as long as the CFC is engaged primarily in legitimate business activities primarily with unrelated parties. In sum, current U.S. treatment of CFC active financing income is more restrictive than the treatment afforded such income by many of the United States' competitors.

Active financial services income is universally recognized as active trade or business income. Thus, if the current law provision were permitted to expire at the end of this year, U.S. financial services companies would find themselves at a significant competitive disadvantage vis-a-vis all their major foreign competitors when operating outside the United States. In addition, because the U.S. active financing exception is currently temporary, it denies U.S. companies the certainty their foreign competitors have. The need for certainty in this area cannot be overstated. U.S. companies need to know the tax consequences of their business operations. Over the last two years US companies have implemented numerous system changes in order to comply with two very different versions of the active financing law, and are unable to take appropriate strategic action if the tax law is not stable.

The Active Financing Exception to Subpart F Is Essential to the Competitive Position of American Financial Services Industries in the Global Marketplace

The financial services sector is the fastest growing component of the U.S. trade in services surplus (which is expected to exceed $80 billion this year). It is therefore very important that the Congress act to maintain a tax structure that does not hinder the competitive efforts of the U.S. financial services industry, rather than allowing the active financing exception to subpart F to expire (and thereby revert to a regime that penalizes U.S.-owned financial services companies).

The growing interdependence of world financial markets has highlighted the urgent need to rationalize U.S. tax rules that undermine the ability of American financial services industries to compete in the international arena. From a tax policy perspective, financial services businesses should be eligible for the same U.S. tax treatment of worldwide income as that of manufacturing and other non-financial businesses. The inequitable treatment of financial services industries under prior law jeopardized the international expansion and competitiveness of U.S.-based financial services companies, including finance and credit entities, commercial banks, securities firms, and insurance companies.

This active financing provision is particularly important today as the U.S. financial services industry is the global leader and plays a pivotal role in maintaining confidence in the international marketplace. Also, recently concluded trade negotiations have opened new foreign markets for this industry, and it is essential that our tax laws complement this trade effort. The Congress must not allow the tax code to revert to penalizing U.S.-based companies upon expiration of the temporary provision this year.

The Active Financing Exception Should Be Made Permanent.

According to Ways and Means Committee member Amo Houghton's floor statement during the debate on the Conference Report on the 1997 legislation that first enacted an active financing exception to subpart F, the fact that the provision would sunset after one year was "a function of revenue concerns, not doubts as to its substantive merit." [4] Indeed, even in the course of subjecting the original active financing exception to a (now defunct) line-item veto, the Administration acknowledged, and continues to acknowledge that the "primary purpose of the provision was proper." [5]

The international growth of American finance and credit companies, banks, securities firms, and insurance companies will be impaired by an "on-again, off-again"

[4] Congressional Record, July 31, 1997.

[5] White House Statement, August 11, 1997.

system of annual extensions that does not allow for certainty. Making this provision a permanent part of the law would enhance the position of the U.S. financial services industry.

CONCLUSION

On behalf of the entire American financial services industry, the Coalition of Service Industries urges the Ways and Means Committee to adopt H.R. 681, the bipartisan bill (recently introduced by Reps. McCrery, Neal, and other members of the committee) to make the active financing exception to subpart F permanent. H.R. 681 would provide a consistent, equitable, and stable international tax regime for the U.S. financial services industry.

SIGNATORIES:

American Bankers Association
American Council of Life Insurance
American Financial Services Association
American Insurance Association
The Bankers Roundtable
Coalition of Finance and Credit Companies
Coalition of Service Industries
Council of Insurance Agents and Brokers
National Association of Manufacturers
Securities Industry Association
The New York Clearing House Association L.L.C.
The Tax Council
US Council for International Business

Statement of Coalition to Preserve Employee Ownership of S Corporations

This statement is respectfully submitted on behalf of the Coalition to Preserve Employee Ownership of S Corporations ("Coalition") in connection with the Committee's hearings on revenue provisions included in the President's fiscal year 2000 budget. The Coalition appreciates the Committee's interest in public comments on the Administration's budget proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular—the proposal to repeal the recently-enacted provision of The Taxpayer Relief Act of 1997 ("1997 Act") that exempts S corporation income that flows through to an ESOP shareholder from the unrelated business income tax ("UBIT"). As explained below, we believe that the 1997 Act provision is furthering the goal Congress intended of facilitating employee ownership of closely-held businesses and should not be repealed; that it is inappropriate as a matter of tax policy to keep changing tax laws upon which businesses rely; that the Administration's tax proposal is inconsistent with the general intent of Congress underlying Subchapter S, is overly complex, and would impose a new tax burden on employees; and that the proposal cannot be justified on "anti-tax shelter" grounds. Therefore, we respectfully request this Committee to reject the Administration's proposal and to keep in place the law it enacted not two years ago.

BACKGROUND

ESOPs provide an opportunity for millions of Americans to own a piece of the businesses for which they work. They not only provide greater incentives for employees to help the companies grow, but also play a critical role in the employees' retirement planning strategies. As explained below, Congress recently has taken important steps to remove some of the barriers to employee ownership that existed for closely-held businesses. The Coalition commends the Congress for its recognition of the value of employee ownership and hopes that this Committee will continue to support employee ownership in the future.

In the Small Business Job Protection Act of 1996 (the "1996 Act"), Congress allowed ESOPs to be shareholders of S corporations, in recognition of the fact that the previous-law "prohibition of certain tax-exempt organizations being S corporation shareholders may have inhibited employee-ownership of closely-held businesses." Joint Committee on Taxation's *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS–12–96). The 1996 Act, however, included a number of restrictive tax rules with respect to ESOPs of S corporations that generally made employee ownership of an S corporation unattractive. For example, the 1996 Act provided that:

The income of the S corporation that flowed through to the ESOP shareholder, as well as any gain on the sale of S corporation stock, would be treated as unrelated business taxable income ("UBTI") and would be subject to tax at the ESOP level.

Thus, the S corporation income would be subject to tax twice—once to the ESOP and once to the participants upon distribution.

The increased deduction limitation under Section 404(a)(9) of the Internal Revenue Code of 1986, as amended ("Code"), would not apply to S corporations. As a result, even though a C corporation generally can deduct contributions to an ESOP that are made to allow the ESOP to pay interest and principal on the loan it incurred to acquire the corporation's stock, up to an amount equal to 25 percent of the compensation paid or accrued to employees under the plan, an S corporation generally is limited to a deduction for contributions equal to 15 percent of the compensation paid or accrued to such employees.

The deduction for dividends paid on certain employer securities under Code Section 404(k)(1) would not be available to S corporations. As a result, even though a C corporation may deduct the amount of certain cash dividends that ultimately are passed through to the participants of the ESOP, an S corporation is not entitled to such a deduction.

The special "rollover" rules of Code Section 1042 that are designed to encourage the contribution of employer stock to ESOPs would not apply to S corporation stock. As a result, even though shareholders may be able to defer gain on the sale of C corporation stock to an ESOP if they reinvest the proceeds in certain qualifying securities, such deferral is not available on the sale of S corporation stock.

In the 1997 Act, Congress decided to repeal the first of these restrictions, such that S corporation income or loss that passes through to an ESOP shareholder, and any gain or loss on the sale by the ESOP of S corporation stock, would not be subject to UBIT. The legislative history indicates that this change was made because the Congress believed "that treating S corporation income as UBTI is not appropriate because such amounts would be subject to tax at the ESOP level, and also again when benefits are distributed to ESOP participants." S. Rept. 105–33 (105th Cong., 1st Sess.), at p. 80. This change became effective for taxable years beginning after December 31, 1997. In reliance on this law change, many employee-owned businesses have elected S corporation status, in some cases increasing the amount of stock owned for the benefit of their employees. Further, some existing S corporations have established ESOPs. Finally, some corporations are in the process either of establishing ESOPs or restructuring so that they will be eligible to elect S corporation status. These companies are furthering the goal of increasing employee ownership that Congress was trying to advance in enacting the 1997 Act provision.

Now, barely a year after the 1997 Act provision became effective, the Administration is asking the Congress to reject the decision it made in the 1997 Act. In particular, the Administration has included in the "corporate tax shelter" section of its budget a proposal to repeal the 1997 Act provision and, instead, to allow an S corporation ESOP a deduction for distributions to participants and beneficiaries to the extent of the S corporation income on which it has paid UBIT. The proposal also would modify net operating loss rules in effect to allow for the carryback of "excess" distribution deductions for 2 years, and the carryforward of such deductions for 20 years. The proposal would be effective for tax years beginning after the date of first committee action. Thus, it would apply to income and gain of corporations that already have ESOPs and/or that already have converted to S corporation status, as well as to corporations that are in the process of establishing ESOPs or converting to S corporation status.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

The Coalition believes that the Administration's proposal is fundamentally flawed for the reasons set forth below.

The 1997 Act Provision Is Furthering the Laudable Goal of Increasing Employee Ownership and Should Not Be Repealed

As indicated above, Congress enacted the 1996 and 1997 Act provisions regarding S corporation ESOPs in order to remove obstacles that had deterred employee ownership of closely-held corporations. Thus far, these provisions have been successful in achieving this objective of facilitating employee ownership. As a direct result of the law changes, employees have increased their ownership of closely-held businesses, shareholders have decided to transfer more stock to ESOPs, and S corporations that previously could not have had ESOPs have been able to give their employees an ownership interest in the business. It is virtually certain that Congress's decisions in 1996 and 1997 will encourage even greater employee ownership in the future. It makes no sense to repeal a provision which is doing exactly what Congress intended it to do and which is furthering a valuable policy goal.

It Is Inappropriate as a Matter of Tax Policy to Change a Tax Law on Which Businesses Have Relied in Making Costly Business Decisions

The Coalition also believes it would be grossly inappropriate as a matter of tax policy to encourage ESOP ownership of S corporations in 1997 and, not two years later, to fundamentally alter the tax consequences of such ownership. As explained further below, converting to S corporation status, selling more stock to an ESOP, and establishing an ESOP are all important decisions that have real economic consequences. Businesses that are considering these actions should be able to make their decisions based on a relatively stable set of tax rules, rather than to have to suffer from tax laws that become effective in one tax year and are repealed in the next.

Corporations that converted to S corporation status in reliance on the 1997 Act provision (or that are in the process of converting) have had to weigh the costs and benefits of their decision in order to determine whether it was (or is) prudent. As indicated above, for a company with an ESOP, converting to S corporation status involves losing certain benefits (such as Code Sections 404(a)(9) and 404(k)(1)) that are available to C corporations, but not to S corporations. Further, converting to S corporation status in many cases involves eliminating the economic interests of "ineligible" shareholders; restructuring debt, options and other arrangements that could be recharacterized as a "second class of stock"; implementing new shareholders' agreements; paying a "LIFO recapture tax," etc. Companies that also elected to treat subsidiaries as "Qualified Subchapter S Subsidiaries" will have lost forever their basis in the stock of such subsidiaries, which could have significant negative consequences in the event of a future sale of those businesses. If the 1997 Act provision had not been enacted, these companies likely would not have incurred the costs, or accepted the consequences, associated with becoming S corporations. It would be improper from a tax policy perspective to encourage conversions in 1997 and to fundamentally change the consequences thereof not more than two years later.

Similarly, companies that have increased the extent to which they are employee owned, or that are in the process of establishing ESOPs, have relied on the 1997 Act provision in determining whether the costs of establishing ESOPs are outweighed by the benefits. In this regard, it is critical to understand that establishing an ESOP is a very costly process. It typically involves, among other things, conducting a feasibility study; obtaining valuations; making comprehensive changes to the overall compensation arrangements; and making difficult decisions about the extent to which employees should have access to information about, and be involved in, the business. ESOPs also are subject to numerous regulatory and disclosure requirements by the Department of Labor. In addition, in the case of a leveraged ESOP, significant financing costs may be incurred. Companies that undertake actions with such significant consequences and costs should be able to rely on a relatively stable set of tax laws.

The Administration's Proposal Not Only Is Complex, But Also Could Result in S Corporation Income Being Subject to Two Levels of Tax and in Employees Bearing a New Tax Burden

As a general matter, Congress has recognized throughout Subchapter S that, subject to limited exceptions, S corporation income should only be subject to one level of tax. However, as explained below, the Administration's proposal in some situations improperly would result in S corporation income being subject to two levels of tax—one at the ESOP level and one at the participant level. Such a result not only would be inconsistent with the general Congressional intent underlying Subchapter S, but also would create an untenable new tax burden on the employee-owners of ESOP-owned companies.

The Administration's proposal apparently attempts to ensure that S corporation income is subject to only one level of tax by introducing a new deduction mechanism. However, this deduction mechanism not only introduces needless complexity into an already overly complex tax law, but also is fundamentally flawed. For example, assume an ESOP had S corporation income in excess of distributions for a number of years prior to the termination or revocation of the corporation's S election. Under the Administration's proposal, the S corporation earnings would be subject to immediate tax at the ESOP level. However, if the ESOP distributed those earnings to participants more than two years after the corporation terminated or revoked its S corporation election, neither the carryback nor carryforward provisions of the proposal likely would be useful because the ESOP would be unlikely to have earnings subject to UBTI at that time (i.e., after the corporation has become a C corporation). Thus, the S corporation earnings in effect would be subject to tax at both the ESOP level (when earned) and the participant level (when distributed), with the employees bearing the burden of the double-level tax.

By contrast, the Congressional decision in the 1997 Act to exempt S corporation income from UBIT at the ESOP level is simple and ensures that S corporation income properly is subject to tax only once—when the income is distributed to participants. The Coalition strongly endorses this decision and encourages this Committee not to entertain the introduction of a complex deduction mechanism that is technically flawed, can engender tax results inconsistent with the general intent underlying Subchapter S, and would produce a new tax burden on employees.

Repealing the 1997 Act Provision Cannot Be Justified on "Anti-Tax Shelter" Grounds

As indicated above, the Administration included its proposal to repeal the 1997 Act provision as part of the "corporate tax shelter" section of its budget. As should be apparent from the above, the 1997 Act provision is playing a valuable role in fostering employee ownership of closely-held businesses and enabling people to enhance their retirement savings. Members of this Coalition that have converted to S corporation status, established ESOPs, or given ESOPs greater stakes in the business are doing exactly what the Congress intended when it enacted the 1997 Act provision—they are not engaging in a tax shelter, taking advantage of a loophole, or otherwise engaging in an abusive transaction.

The Coalition understands that this Committee may be concerned about particular transactions in which taxpayers may be using ESOPs in a manner not intended by the Congress in 1997. For example, the Joint Committee on Taxation, in its *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal*, suggested that there may be concerns regarding S corporation ESOPs in cases where there are only one or two employees. In addition, it referenced a technique described by Prof. Martin Ginsburg in which the 1997 Act provision can be used to create a "tax holiday" for other shareholders of an S corporation. [1] If Congress is concerned about particular transactions, the appropriate response is to craft narrow solutions targeting those transactions, rather than to reject wholesale the decision made in the 1997 Act to further employee ownership of closely-held companies.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to approve the Administration's proposal. If the Committee is concerned about perceived abuses, the Coalition would be happy to work with the Committee and its staff in devising an appropriate solution that is tailored to the particular transactions with which the Committee is concerned.

The Coalition appreciates the Committee's interest in its views on this significant issue.

This testimony was prepared on behalf of the Coalition by Arthur Andersen LLP.

Statement of Committee of Annuity Insurers

The Committee of Annuity Insurers is composed of forty-two life insurance companies that issue annuity contracts, representing approximately two-thirds of the annuity business in the United States. The Committee of Annuity Insurers was formed in 1981 to address Federal legislative and regulatory issues affecting the annuity industry and to participate in the development of Federal tax policy regarding annuities. A list of the member companies is attached at the end of this statement. We thank you for the opportunity to submit this statement for the record.

All of the Administration's proposals relating to the taxation of life insurance companies and their products are fundamentally flawed. However, the focus of this statement is the Administration's proposal to increase the so-called "DAC tax" imposed under IRC section 848 and, in particular, the increase proposed with respect to annuity contracts used for retirement savings outside of pension plans ("nonqualified annuities"). The Administration's proposal reflects unsound tax policy and, if enacted, would have a substantial, adverse effect on private retirement savings in America. As was the case last year, the Administration has demonstrated that it does not understand the important role that annuities and life insurance play in

[1] Ginsburg, "The Taxpayer Relief Act of 1997: Worse Than You Think," 76 *Tax Notes* 1790 (September 29, 1997).

assuring Americans that they will have adequate resources during retirement and adequate protection for their families.

Annuities are widely owned by Americans. At the end of 1997, there were approximately 38 million individual annuity contracts outstanding, nearly three times the approximately 13 million contracts outstanding just 11 years before. The premiums paid into individual annuities—amounts saved by individual Americans for their retirement—grew from approximately $34 billion in 1987 to $90 billion in 1997, an average annual increase of greater than 10 percent.

Owners of non-qualified annuities are predominantly middle-income Americans saving for retirement. The reasons for this are obvious. Annuities have unique characteristics that make them particularly well-suited to accumulate retirement savings and provide retirement income. Annuities allow individuals to protect themselves against the risk of outliving their savings by guaranteeing income payments that will continue as long as the owner lives. Deferred annuities also guarantee a death benefit if the owner dies before annuity payments begin.

The tax rules established for annuities have been successful in increasing retirement savings. Eighty-four percent of owners of non-qualified annuities surveyed by The Gallup Organization in 1998 reported that they have saved more money than they would have if the tax advantages of an annuity contract had not been available. Almost nine in ten (88%) reported that they try not to withdraw any money from their annuity before they retire because they would have to pay tax on the money withdrawn.

As discussed below, the proposal contained in the Administration's FY 2000 budget to increase the DAC tax is in substance a tax on owners of non-qualified annuity contracts and cash value life insurance. It would make these products more expensive and less attractive to retirement savers. It would also lower the benefits payable to savers and families. Furthermore, as also discussed below, the DAC tax is fundamentally flawed and increasing its rate would simply be an expansion of bad tax policy.

1. The Administration's DAC proposal is in substance a tax on the owners of annuities and life insurance.

Last year, the Administration's budget proposals included several direct tax increases on annuity and life insurance contract owners, including imposition of tax when a variable contract owner changed his or her investment strategy and a reduction in cost basis for amounts paid for insurance protection. The proposals were rightly met with massive bipartisan opposition and were rejected. This year's budget proposal on DAC is simply an attempt to increase indirectly the taxes of annuity and life insurance contract owners. We urge this Committee to reject the Administration's back door tax increase on annuity and life insurance contract owners in the same decisive manner in which the Committee rejected last year's proposed direct tax increases.

IRC section 848 denies life insurance companies a current deduction for a portion of their ordinary and necessary business expenses equal to a percentage of the net premiums paid each year by the owners of certain types of contracts. These amounts instead must be capitalized and then amortized over 120 months. The amounts that currently must be capitalized are 1.75 percent of non-qualified annuity premiums, 2.05 percent of group life insurance premiums, and 7.70 percent of other life insurance premiums (including noncancellable or guaranteed renewable accident and health insurance). Under the Administration's proposal, these categories of contracts would be modified and the percentages would be dramatically increased. Specifically, the rate for annuity contracts would almost triple to 5.15 percent while the rate for individual cash value life insurance would almost double to 12.85 percent.

The tax resulting from the requirements of section 848 is directly related to the amount of premiums paid by the owners of the contracts. Thus, as individuals increase their annuity savings (by paying more premiums), a company's taxes increase—the higher the savings, the higher the tax. It is clear that since the enactment of DAC in 1990, the DAC tax has been passed through to the individual owners of annuities and life insurance. Some contracts impose an express charge for the cost of the DAC tax, for example, while other contracts necessarily pay lower dividends or less interest to the policyholder. Still other contracts impose higher general expense charges to cover the DAC tax. (See *The Wall Street Journal*, December 10, 1990, "Life Insurers to Pass Along Tax Increase.")

According to the Joint Committee on Taxation, the increased capitalization percentages proposed in the Administration's FY 2000 budget will result in increased taxes of $3.73 billion for the period 1999–2004 and $9.48 billion for the period 1999–2009. This tax increase will largely come from middle-income Americans who are purchasing annuities to save for retirement and cash value life insurance to protect their families. According to a Gallup survey conducted in April 1998, most owners of non-qualified annuities have moderate annual household incomes. Three-quarters (75%) have total annual household incomes under $75,000. Eight in ten owners of non-qualified annuities state that they plan to use their annuity savings for retirement income (83%) or to avoid being a financial burden on their children (82%).

The Administration's proposal will discourage private retirement savings and the purchase of life insurance. Congress in recent years has become ever more focused on the declining savings rate in America and on ways to encourage savings and retirement savings in particular. As described above, Americans have been saving more and more in annuities, which are the only non-pension retirement investments that can provide the owner with a guarantee of an income that will last as long as the owner lives. Life insurance contracts can uniquely protect families against the risk of loss of income. Increasing the cost of annuities and cash value life insurance and reducing the benefits will inevitably reduce private savings and the purchase of life insurance protection.

2. CONTRARY TO THE ADMINISTRATION'S CLAIMS, AN INCREASE IN THE DAC TAX IS NOT NECESSARY TO REFLECT THE INCOME OF LIFE INSURANCE COMPANIES ACCURATELY.

The Administration claims that the increases it proposes in the DAC capitalization percentages are necessary to accurately reflect the economic income of life insurance companies. In particular, the Administration asserts that "life insurance companies generally capitalize only a fraction of their policy acquisition expenses." In fact, as explained below, life insurance companies already more than adequately capitalize the expenses they incur in connection with issuing annuity and life insurance contracts. The Administration's proposal would further distort life insurance company income simply to raise revenue.

As a preliminary matter, the Administration cites certain data that life insurance companies report to state insurance regulators as a basis for its claim that only a fraction of policy selling expenses are being capitalized. In particular, the Administration points to the ratio of commissions to net premiums during the period 1993 − 1997, and notes that the ratio is higher than the current DAC capitalization percentage. The Administration's ratios present an inaccurate and misleading picture of the portion of commissions being capitalized under current law.

The Administration's ratios apparently treat expense allowances paid on reinsured contracts as commissions and in doing so effectively count those amounts twice. As a result, the numerators in the Administration's ratios are significantly overstated. If expense allowances paid in connection with reinsurance are accounted for properly, the ratio of commissions to net premiums is significantly lower than described by the Administration.

More importantly, the current tax rules applicable to life insurance companies capitalize policy selling expenses not only through the section 848 DAC tax, but also by requiring (in IRC section 807) reserves for life insurance and annuity contracts to be based on a "preliminary term" or equivalent method. It is a matter of historical record that preliminary term reserve methods were developed because of the inter-relationship of policy selling expenses and reserves. Since the early 1900's, when preliminary term reserve methods began to be accepted by state insurance regulators, the relationship between policy reserves and a life insurance company's policy selling expenses has been widely recognized. See, e.g., K. Black, Jr. and H. Skipper, Jr, *Life Insurance* 565–69 (12th ed. 1994); *McGill's Life Insurance* 401–408 (edited by E. Graves and L. Hayes, 1994).

Under a preliminary term reserve method, the reserve established in the year the policy is issued is reduced (from a higher, "net level" basis) to provide funds to pay the expenses (such as commissions) the life insurer incurs in issuing the contract. The amount of this reduction is known as the "expense allowance," i.e., the amount of the premium that may be used to pay expenses instead of being allocated to the reserve. Of course, the life insurance company's liability for the benefits promised to the policyholder remains the same even if a lower, preliminary term reserve is established. As a result, the amount added to the reserve in subsequent years is increased to take account of the reduction in the first year.

In measuring a life insurance company's income, reducing the first year reserve deduction by the expense allowance is economically equivalent to computing a higher, net level reserve and capitalizing, rather than currently deducting, that portion of policy selling expenses. Likewise, increasing the reserve in subsequent years is equivalent to amortizing those policy selling expenses over the subsequent years. Thus, under the current income tax rules applicable to life insurance companies, policy selling expenses are capitalized both under the section 848 DAC tax and through the required use of preliminary term reserves. The Administration's FY 2000 budget proposal completely ignores this combined effect.

This relationship between policy selling expenses and preliminary term reserves has been recognized by Congress. In accordance with the treatment mandated by the state regulators for purposes of the NAIC annual statement, life insurance companies have always deducted their policy selling expenses in the year incurred in computing their Federal income taxes. Until 1984, life insurance companies also computed their tax reserves based on the reserve computed and held on the annual statement. However, under the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"), if a company computed its annual statement reserves on a preliminary term method, the reserves could be recomputed on the higher, net level method for tax purposes. Because companies were allowed to compute reserves on the net level method and to deduct policy selling expenses as incurred, life insurance companies under the 1959 Act typically incurred a substantial tax loss in the year a policy was issued.

When Congress was considering revisions to the tax treatment of life insurance companies in 1983, concern was expressed about the losses incurred in the first policy year as a result of the interplay of the net level reserve method and the current deduction of first year expenses. In particular, there was concern that a mismatching of income and deductions was occurring. As a consequence, as those who participated in the development of the Deficit Reduction Act of 1984 (the "1984 Act") know, Congress at that time considered requiring life insurance companies to capitalize and amortize policy selling expenses.

Congress chose not to change directly the tax treatment of policy selling expenses, however. Rather, recognizing that the effect of the use of preliminary term reserve methods is economically identical to capitalizing (and amortizing over the premium paying period) the expense allowance by which the first year reserve is reduced, Congress decided to alter the treatment of selling expenses indirectly by requiring companies to use preliminary term methods, rather than the net level method, in computing life insurance reserves.

Although the published legislative history of the 1984 Act does not explicitly comment on this congressional decision to address the treatment of selling expenses through reduction of the allowable reserve deduction, the legislative history of the Tax Reform Act of 1986 does. In 1986, Congress became concerned that there was a mismatching of income and deductions in the case of property and casualty insurers. In particular, some thought that allowing a property and casualty company a deduction for both unearned premium reserves and policy selling expenses resulted in such a mismatching.

Again, recognizing the relationship between the treatment of reserves and selling expenses, Congress chose to reduce the unearned premium reserve deduction of property and casualty insurers by 20 percent, while allowing selling expenses to remain currently deductible. See I.R.C. section 832(b)(4). The legislative history of this rule noted that "this approach is equivalent to denying current deductibility for a portion of the premium acquisition costs." Jt. Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, at p. 595 ("1986 Act Bluebook"). Moreover, Congress specifically excluded life insurance reserves that were included in unearned premium reserves from the 20 percent reduction. See I.R.C. section 832(b)(7). It did so, according to the legislative history, because under the 1984 Act life insurance reserves "are calculated . . . in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses." See *1986 Act Bluebook* at p. 595 (emphasis added).

In summary, life insurance companies are already over capitalizing policy selling expenses for income tax purposes because of the combination of the current DAC tax and the mandated use of preliminary term reserves. In these circumstances, increasing the DAC capitalization percentages will not result in a clearer reflection of the income of life insurance companies. To the contrary, increasing the percentages as the Administration proposes would further distort life insurance company income simply to raise revenue.

3. CONTRARY TO THE ADMINISTRATION'S SUGGESTION, AN INCREASE IN THE DAC TAX IS INCONSISTENT WITH GAAP ACCOUNTING.

The Administration's explanation of the DAC proposal implies that increases in the DAC percentages are consistent with generally accepted accounting principles (GAAP). The Administration states that "[l]ife insurance companies generally capitalize only a portion of their actual policy acquisition costs. In contrast, when preparing their financial statements using [GAAP], life companies generally capitalize their actual acquisition costs." What the Administration's explanation fails to note is that, while it is correct that under GAAP accounting actual acquisition costs are capitalized, GAAP accounting does not mandate the use of preliminary term reserves. In fact, no system of insurance accounting "doubles up" on capitalization by requiring a combination of capitalization of actual policy acquisition costs combined with the use of preliminary term reserves.

It is clear from the legislative history of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act") that Congress expressly considered and rejected GAAP as a basis for accounting for life insurance company policy selling expenses. The Chairman of the Senate Budget Committee inserted in the Congressional Record the language submitted by the Senate Finance Committee describing the section 848 DAC tax. 136 Congressional Record at S15691 (Oct. 18, 1990). In this explanation, the Finance Committee recognized that, while there were some potential benefits to the GAAP approach, there were a number of drawbacks to it. As a result, the Finance Committee chose a proxy approach of amortizing a percentage of premiums over an arbitrary 10 year period, rather than capitalizing actual selling expenses and amortizing them over the actual life of the contracts. In doing so, the Finance Committee observed that

> The Committee recognizes that this approach to the amortization of policy acquisition expenses does not measure actual policy acquisition expenses. However, the Committee believes that the advantage of retaining a theoretically correct approach is outweighed by the administrative simplicity of this proxy approach. Further, the Committee believes that the level of amortizable amounts obtained under this proxy approach should, in most cases, understate actual acquisition expenses. . . . Id.

The House legislative history contains similar explanatory material. See Legislative History of Ways and Means Democratic Alternative (WMCP 101–37), October 15, 1990, at 27–28.

In short, when Congress enacted the DAC tax in 1990, it knew that the proxy percentages did not capitalize the full amount of acquisition expenses as does GAAP accounting. However, as discussed above, the combination of the current DAC percentages with the mandated use of preliminary term reserves already results in two different capitalization mechanisms. If GAAP accounting is the appropriate model for taxing life insurance companies, as the Administration suggests, then the DAC tax should be repealed, not increased.

In conclusion, the Committee of Annuity Insurers urges the Committee to reject the Administration's proposal to increase the section 848 DAC tax. The proposal is simply a disguised tax on the owners of annuities and life insurance contracts. Furthermore, the proposal lacks any sound policy basis and further distorts the income of life insurance companies.

THE COMMITTEE OF ANNUITY INSURERS

Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton, Conseco, Inc., Carmel, IN
COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
GE Life and Annuity Assurance Company, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, MI
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln National Corporation, Fort Wayne, IN
ManuLife Financial, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY

Minnesota Life Insurance Company, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New England Life Insurance Company, Boston, MA
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT
Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corporation, Seattle, WA
Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement
Equities Fund (TIAA-CREF), New York, NY
The Principal Financial Group, Des Moines, IA
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

Statement of Committee to Preserve Private Employee Ownership

INTRODUCTION

This statement is submitted on behalf of the Committee to Preserve Private Employee Ownership ("CPPEO"), which is a separately funded and chartered committee of the S Corporation Association. As of March 1, 1999, 19 employers have joined CPPEO and over 20,000 employees in virtually every state in the country are represented by companies that belong to CPPEO.

CPPEO welcomes the opportunity to submit this statement for the written record to the Committee on Ways and Means regarding two of the proposals in the President's Fiscal Year 2000 Budget. CPPEO strongly opposes the proposal to effectively repeal the provision in the Taxpayer Relief Act of 1997 (the "1997 Act")[1] that allowed S corporations to create ESOPs in order to promote employee stock ownership and employee retirement savings for S corporation employees. CPPEO urges the Ways and Means Committee to reject the Administration's S corporation ESOP proposal and continue to allow S corporations to have ESOP shareholders as contemplated in the 1997 Act. CPPEO also strongly opposes the Administration's proposal to tax "large" C corporations and their shareholders upon a conversion to S corporation status. CPPEO urges the Ways and Means Committee to reject this proposal, which has been included in the President's budget for the past three years and has been rejected each year, on the grounds it would inhibit the ability of S corporations to acquire C corporations, would impose burdensome complexity, and may represent a first step in an attempt to eliminate S corporations as a form of doing business.

LEGISLATIVE HISTORY OF S CORPORATION ESOPS

In the early 1990's, efforts began to enact legislation that would allow S corporation employees to enjoy the benefits of employee stock ownership that were conferred on C corporation employees under the ESOP provisions. Finally, in 1996 Congress included a provision in the Small Business Jobs Protection Act of 1996 (the "1996 Act")[2] that allowed S corporations to have ESOP shareholders, effective for taxable years beginning after December 31, 1997, so that S corporation employees could partake in the benefits of employee ownership that were already afforded to employees of C corporations. This provision, which was added just prior to enactment, did not result in a viable method to allow S corporation ESOPs, though it clearly expressed Congress' intent that S corporations should be allowed to have employee plan owners.

The 1996 Act did not provide S corporation ESOPs with all of the incentives that are provided to encourage C corporation ESOPs. For example, under Internal Revenue Code section 1042,[3] shareholders that sell employer stock to a C corporation ESOP are allowed to defer the recognition of gain from such sale. In addition, under

[1] 1 P.L. 105–34.
[2] 2 P.L. 104–188.
[3] 3 All "section" references are to the Internal Revenue Code of 1986, as amended.

section 404(a)(9), C corporations are allowed to make additional deductible contributions that are used by an ESOP to repay the principal and interest on loans incurred by the ESOP to purchase employer stock. C corporations are also allowed deductions under section 404(k) for dividends paid to an ESOP that are used either to make distributions to participants or to repay loans incurred by the ESOP to purchase employer stock. In addition, as a practical matter S corporation ESOP participants would be unable to use a substantial tax break—the "net unrealized appreciation" exclusion in section 402(e)(4)—because this benefit applies only to distributions of employer stock, which S corporations typically cannot do, as described below.

These incentives provided to C corporation ESOPs were not provided to S corporation ESOPs and a major disincentive was imposed on S corporation ESOPs by the 1996 Act. A 39.6 percent tax (the unrelated business income tax of section 511, or "UBIT") was imposed on employees' retirement accounts with respect to the ESOP's share of the income of the sponsoring S corporation and any gain realized by the ESOP when it sold the stock of the sponsoring S corporation. The imposition of UBIT on S corporation ESOPs meant that the same income was being taxed twice, once to employees' ESOP accounts and a second time to the employees' distributions from the ESOP. Accordingly, owning S corporation stock through an ESOP would subject employees to double tax on their benefits, while individuals holding S corporation stock directly would be subject to only a single level of tax.

The 1996 Act had another defect that made ESOPs an impractical choice for providing employee retirement benefits to S corporation employees—the right of ESOP participants to demand their distributions in the form of employer securities. S corporations cannot have more than 75 shareholders and cannot have IRAs or certain other qualified retirement plans as shareholders. Therefore, S corporations generally could not adopt ESOPs without taking the risk that the future actions of an ESOP participant could nullify the corporation's election of S corporation status—such as rolling over his or her stock into an IRA.

In the 1997 Act, Congress reaffirmed its policy goal of making ESOPs available to the employees of S corporations and addressed the problems with the ESOP provisions in the 1996 Act. Congress did not provide S corporation ESOPs with all the advantages and incentives provided to C corporation ESOPs, including the favorable tax treatment for shareholders selling stock to the ESOP and increased deductions and contribution limits for the sponsoring employer discussed above, but it did fix the critical problems. The double tax on S corporation stock held by an ESOP was eliminated by exempting income attributable to S corporation stock held by the ESOP from UBIT. Thus, only one level of tax was to be imposed, which would be imposed on the ESOP participant when he or she received a distribution from the ESOP. S corporation ESOPs also were given the right to distribute cash to participants in lieu of S corporation stock in order to address the problems of ineligible S corporation shareholders and the numerical limit on S corporation shareholders.

In 1997 it was clear that a key feature of the legislation was that S corporation ESOPs would not have the same incentives afforded to C corporation ESOPs. The incentives provided to C corporation ESOPs that were not allowed to S corporation ESOPs under the 1996 Act, as described above, would continue to be allowed only to C corporation ESOPs. However, S corporation ESOPs would enjoy two benefits not available to C corporation ESOPs.

First, the income of S corporation ESOPs under the 1997 Act is subject to only a single level of tax. This is an inherent attribute of the way S corporations and their shareholders are taxed, and in fact is the fundamental characteristic of the S corporation tax regime. No one, including the Administration, disputes that only one level of tax should be imposed on S corporations and their shareholders. The second benefit provided to S corporation ESOPs is that the one level of tax is deferred until benefits are distributed to ESOP participants. Considerable thought was given in 1997 to whether this deferral of tax should be allowed. Various ways of taxing S corporation ESOPs and their participants were considered in 1997, including ways essentially the same as the Administration's proposal, and were rejected as too complex, burdensome, and unworkable. In order to achieve a workable S corporation ESOP tax regime with incentives that were commensurate with those available to C corporation ESOPs, Congress determined that the deferral of the one level of tax, in lieu of the special incentives afforded to C corporation ESOPs, was appropriate. The Administration is rejecting this determination just 18 months after Congress has acted.

THE ADMINISTRATION'S S CORPORATION ESOP PROPOSAL

The Administration proposes to reimpose UBIT on S corporation ESOPs, both new and old. The specific provisions relating to UBIT adopted in the 1997 Act would be repealed. As explained by Assistant Secretary Donald Lubick in his testimony before this Committee, the benefit of tax deferral would be eliminated by reimposing UBIT on S corporation ESOPs. Acknowledging that double taxation of S corporations and their shareholders is not appropriate, the Administration would provide S corporation ESOPs with a special deduction to be used against their liability for UBIT when distributions are made to ESOP participants.

THE ADMINISTRATION'S S CORPORATION ESOP PROPOSAL WOULD FRUSTRATE CONGRESSIONAL POLICY

The Administration's S corporation ESOP proposal would frustrate the Congressional policy of allowing S corporations to establish ESOPs for their employees principally because the Administration proposal will not only end deferral, but also will reinstate double taxation. The Administration's proposal to allow a deduction to the ESOP for distributions to participants will not prevent double taxation.

S corporation ESOPs will be required to pay UBIT for all the years that they hold S corporation stock, but will not be allowed any way to recover those taxes until distributions are made to participants. The rules limiting the timing of distributions by an ESOP to its employee participants, like the rules for all qualified retirement plans, encourage long-term retirement savings and are intended to produce the result that distributions to an employee will occur many years, even decades, after the employee first becomes a participant in the ESOP. A 2-year carryback and a 20-year carryforward of excess deductions will not ensure that the taxes paid by the ESOP over many years, even decades, will be recovered. Thus, there is no assurance that the deduction will prevent double taxation of employee benefits. *In fact, the estimated revenue to be raised by the Administration's proposal is the same as the revenue cost of the 1997 Act, demonstrating that the Administration's proposal is simply an attempt to repeal the provisions of the 1997 Act and is not aimed at preventing unintended uses of current law.*

The Administration's proposed scheme for eliminating tax deferral and attempting to prevent double taxation has another substantial defect. That is, any tax refunds to the ESOP for the tax deductions allowed to the ESOP cannot be fairly allocated and paid to the employee participants. Assume, for the sake of illustration, that employees A and B are the participants in an S corporation ESOP, each owning an equal number of shares of S corporation stock through the ESOP. A and B work for the next 20 years and the ESOP pays tax on the income of the S corporation attributable to their shares of stock. Then A decides to retire and the ESOP sells the shares of stock in A's account to the S corporation and pays A the proceeds. The ESOP would receive a deduction for the distribution to A and would be able to reduce its UBIT liability for the year it makes a distribution to A. In this example, there would be no way the ESOP could use the full amount of the deduction for the year it makes a distribution to A, nor would it be able to fully use the excess amount when it carries the excess deduction back two years. Thus, the ESOP would not be able to realize the full benefit of the deduction, which was supposed to allow the ESOP to recoup the taxes it paid over the past 20 years with respect to the stock in A's account and, presumably, give A that benefit to offset the second level of taxes A will pay. By the time the ESOP realizes all the benefits of the deduction, A will have long ceased to be a participant in the ESOP and those benefits will be allocated to the remaining participant, namely B.

In addition, it is not clear how the ESOP could properly allocate the benefits that it can immediately realize. The deduction is allowed for distributions to participants. After the proceeds from the sale of the stock in A's account are distributed to A, A ceases to be a participant. The ESOP cannot make any additional allocations or distributions to A. As the sole remaining participant, B will receive the benefit of those deductions.

The Administration's proposal also resurrects a problem under ERISA that the 1997 Act eliminated. The imposition of UBIT on S corporation ESOPs raises concerns about fiduciary obligations under ERISA for potential ESOP plan sponsors and trustees. The potential for double taxation and the inequitable allocation of benefits among plan participants will make the establishment of S corporation ESOPs unpalatable to anyone who would be subject to ERISA. In addition, qualified plan trustees typically avoid investments that give rise to UBIT because it obligates the trustee to file a federal income tax return for the plan's UBIT liability. Under the Administration's proposal, the establishment of an S corporation ESOP would necessarily involve making investments that give rise to UBIT liability because ESOPs are required to invest primarily in employer securities.

The Administration's proposal attempts to characterize the treatment of S corporation ESOPs as a corporate tax shelter. The beneficiaries of S corporation ESOPs are employees, not the S corporation. Moreover, the IRS already has an arsenal of anti-abuse tools to deal with any unintended benefits from creating an S corporation ESOP. Current law was enacted to do just what it is doing—encouraging employee ownership of S corporations. *Indeed, advocating the repeal of a successful retirement program directly contradicts the Administration's stated objective of increasing retirement savings, as reflected in the 17 retirement savings proposals included in its fiscal year 2000 budget.*

CONVERSIONS FROM C CORPORATION STATUS TO S CORPORATION STATUS

Under current law, the conversion of a C corporation into an S corporation (whether by electing S corporation status or by merging the C corporation into an existing S corporation) generally does not result in the recognition of gain or loss by either the C corporation or its shareholders. Current law limits the potential for using the tax-free conversion to S corporation status to shift appreciated assets from a C corporation to an S corporation in order to avoid the corporate level tax on the sale of the assets. Under current law, a corporate level tax is imposed on an S corporation if it sells appreciated assets within ten years of acquiring the assets in a conversion from C corporation status. S corporation shareholders are also taxed on the gain, reduced by the amount of tax paid by the S corporation.

THE ADMINISTRATION'S PROPOSAL TO TAX CONVERSIONS TO S CORPORATION STATUS IS BAD TAX POLICY

Under the Administration's proposal, a C corporation and its shareholders would be taxed on a conversion of the C corporation to S corporation status (whether by electing S corporation status or by merger into an existing S corporation), if the value of the corporation on the date of conversion is more than $5 million. By imposing a tax on the merger of C corporations into existing S corporations (and mergers preceded by the election of S corporation status by an existing C corporation), the Administration's proposal would unfairly inhibit the ability of S corporations to expand their businesses through corporate acquisitions. C corporations are allowed to make tax-free corporate acquisitions, but S corporations would be denied that privilege.

This unfair result would, moreover, come at the price of burdensome complexity. The $5 million threshold value for imposing tax on S corporation conversions would create a "cliff" effect that would result in disputes over valuation that would be difficult to resolve for corporations that are not publicly traded. In addition, more rules would be needed to address the murky issues of whether conversions below the $5 million threshold were "abusive" transactions structured to avoid the conversion tax.

The Administration's proposal may represent a first step towards the repeal of the S corporation tax regime. The restrictions on S corporations (primarily the "one class of stock" rule and limitations on the number and type of shareholders) do not compare favorably with the flexibility afforded limited liability companies, which have expanded the availability of corporate limited liability combined with a single level of tax. Therefore, the desirability of S corporation status for newly-formed businesses has been decreased. The Administration's proposal would decrease the desirability of C corporations converting to S corporation status. Enactment of the Administration's proposal would confine S corporation status principally to existing S corporations, at which point the opponents of the S corporation tax regime would challenge the need to preserve a separate tax regime for the benefit of only existing S corporations and their shareholders. The S corporation tax regime has served small businesses well for the past 40 years and there is no good reason to dismantle that regime now.

CONCLUSION

Current law encourages employee ownership of S corporations and promotes employee retirement savings. Current law is working exactly as it was intended to work when Congress amended the ESOP rules for S corporations in the 1997 Act. Accordingly, CPPEO urges this Committee to reject the Administration's S corporation ESOP proposal. The tax and retirement policies reflected in the 1997 Act, resolved just a few months ago, should not now be undone.

In addition, current law fairly treats corporate acquisitions by S corporations the same as corporate acquisitions by C corporations. Accordingly, CPPEO urges this Committee to reject the Administration's proposal to tax conversions to S corporation status. The Administration's proposal is not needed, would unfairly discriminate against S corporations, would add burdensome complexity to the tax law, and would threaten the continued existence of the S corporation tax regime.

[By permission of the Chairman]

Statement of the Conservation Trust of Puerto Rico

INTRODUCTION AND OVERVIEW

This testimony outlines the comments of the Conservation Trust of Puerto Rico ("Conservation Trust" or "Trust") on the Administration's fiscal year 2000 budget proposal to increase, for a five year period, the amount of the rum excise tax that is covered over to Puerto Rico and the U.S. Virgin Islands. The proposal would dedicate to the Conservation Trust a portion of the amount covered over to Puerto Rico. Congressman Phil Crane (R–IL) originally developed this proposal in the 105th Congress, after the Trust lost its funding source in 1996 upon repeal of the Qualified Possession Source Investment Income ("QPSII") provisions of Section 936 of the Internal Revenue Code ("Code").

The Trust strongly supports the short-term funding proposal included in the fiscal year 2000 budget request. Passage of this proposal would allow the Trust to become more independent by building a sufficient endowment to guarantee the Trust's long-term viability. This short-term plan has bipartisan Ways and Means Committee support, led by Congressmen Crane and Rangel (D–NY), and will help the Trust continue to meet its sole mission of preserving and protecting the most ecologically valuable natural lands and historic sites of Puerto Rico.

CONSERVATION TRUST'S PURPOSE AND FINANCING

The Conservation Trust is a non-profit institution specifically created to carry out a joint plan of the U.S. and Puerto Rico for the protection and enhancement of the natural resources and beauty of Puerto Rico. The Trust was established in 1968 by an agreement between the U.S. Department of the Interior and the Government of Puerto Rico. The Trust is classified by the Internal Revenue Service as exempt under 501(c)(3) and 509(a)(3) of the Code as an institution organized and operated to perform the functions of the U.S. and Puerto Rico in the area of conservation. The Commonwealth Department of the Treasury also classifies the Trust as a non-profit institution.

Since its inception, the Trust has acquired more than 6,000 acres of endangered land and through various programs protects an additional 7,000 acres. The Trust's acquisition represents 80% of all land acquired for permanent conservation in Puerto Rico by public or private entities over the last 20 years. The Trust also engages in educational programs which include, among other things, the design of environmental and conservation curricula, the adoption of schools, summer camps, and environmental interpretation of properties, and a reforestation program. Despite the Trust's active role, however, only 5% of the Island is under some protection by either the Federal or Commonwealth conservation agencies or the Conservation Trust.

For the first 10 years of its existence, the Trust was funded through a fee imposed by the Department of the Interior on petroleum and petrochemical companies operating in Puerto Rico under the Oil Import Allocation Program. Upon expiration of the Oil Import Allocation Program, the Trust sustained its activities through the use of income generated by companies doing business in the Island and eligible to take the "possessions tax credit" under Section 936 of the Code. The Trust was authorized by local law to participate in financial transactions that utilized QPSII. Through mid–1996, this funding mechanism generated almost 80% of the Trust's revenues.

SECTION 936 CHANGES ELIMINATED FUNDING SOURCE FOR CONSERVATION TRUST

The Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") phased-down the possessions credit significantly during tax years 1994 to 1998. Additionally, OBRA '93 increased the rum tax cover over from $10.50 to $11.30 for the same five taxable years, ending on September 31, 1998. Viewing the Section 936 legislation as a signal that reliance on the QPSII program was infeasible and the program was at risk of being eliminated altogether after 1998, the Trust made significant adjustments to its land acquisition plans and capital improvement programs after passage of OBRA '93. In addition to these adjustments, a major portion of the Trust's yearly income was reallocated to build an endowment fund designed to reach $90 million by 1998.

In 1996, however, Congress passed the Small Business Job Protection Act. This legislation repealed the QPSII provisions of Section 936, thereby cutting off an essential outside funding source much earlier than any such loss was expected.

The elimination of the Section 936 and the QPSII provisions has had a substantial negative impact on the Trust's operations. Specifically, the repeal has eliminated the Trust's primary income source used to meet endowment goals. Since passage of the Small Business Job Protection Act in 1996, the volume of funds invested in Trust notes has decreased from an average of $1.3 billion to $1.4 billion to approximately $550 million, of which $120 million is from pre–1997 long-term investments. Additionally, the net income made per transaction has diminished because of the increase in the rates the Trust must now pay to obtain new financing.

The loss of Section 936 income has also impeded the Trust's ability to complete pre–1996 conservation efforts as well as start new projects. Prior to the repeal of Section 936, the Trust acquired and began restoring Esperanza, an historic sugar mill site on the Island. The Trust had also planned to purchase a salt landing necessary to preserving the fish and migratory bird population on the Island. The loss of QPSII funds, however, severely limited the Trust's ability to continue restoration efforts at Esperanza or to make additional acquisitions, such as the salt landing. The Trust's financial constraints are also inhibiting its ability to properly address the damage resulting from Hurricane Georges.

The Trust has proven extremely effective at advancing its mission, however, there is still much more work that needs to be done. These goals will be impossible to reach without short-term financing to build an endowment sufficient to guarantee the Trust's viability. Congressman Crane's proposal, which the Administration included in its Fiscal Year 2000 budget request, will provide such short-term support.

Description of Current Law and Proposed Solution for the Trust

I. Current law.

Section 5001 of the Internal Revenue Code ("the Code") imposes an excise tax of $13.50 per proof gallon on distilled spirits made or imported into the U.S. Section 7652 of the Code further provides for a payment (a "cover over") of $10.50 per proof gallon of the excise tax levied on rum that is imported into the U.S., Puerto Rico, or the Virgin Islands.

OBRA '93 provided that, for a five-year period, $11.30 of the excise tax be covered over to the treasury of Puerto Rico. After September 30, 1998, the amount covered over to Puerto Rico returned to the pre-OBRA '93 amount of $10.50.

II. Proposed Solution.

The Administration's fiscal year 2000 budget proposal would increase the rum excise cover over from $10.50 to $13.50 per proof gallon for Puerto Rico and the Virgin Islands for five years, beginning October 1, 1999. Of such amount that is covered over to Puerto Rico, $.50 per proof gallon would be dedicated to the Trust. The proposal would be effective for rum imported or brought into the U.S. after September 30, 1999 and before October 1, 2004. This proposal is also reflected in legislation (S. 213) that Senator Daniel P. Moynihan (D–NY) introduced this year.

Conclusion

Enactment of the cover-over proposal would allow the Trust to become more independent by building a sufficient endowment to guarantee the Trust's long-term viability. This short-term infusion would ensure that the Trust's managers, including the Department of the Interior, continue the Trust's mission of preserving the environmental and historic beauty of the Island of Puerto Rico.

Statement of Richard C. Smith, Partner, Bryan Cave LLP, Niche Marketing, Inc., Costa Mesa, California, and Economics Concepts, Inc., Phoenix, Arizona

Mr. Chairman and Members of the Committee:

My name is Richard C. Smith, and I am a partner in the Phoenix, Arizona office of Bryan Cave LLP, a leading international law firm, where a significant portion of my practice involves counseling clients with respect to employee benefits and planning employee benefit plans and programs. I am submitting this statement for the record today on behalf of two clients that sponsor welfare benefit plans, Niche

Marketing, Inc. of Costa Mesa, California, and Economic Concepts, Inc. of Phoenix, Arizona.

We believe that the Administration's proposal to further limit the deductibility of contributions to multiple employer welfare benefit plans under sections 419 and 419A of the Internal Revenue Code is ill-advised and will undermine the ability of smaller employers to fund bona fide benefits to their employees at precisely the times in the business cycle when those benefits would be most needed. In our opinion, the Administration's proposal has gone further than is necessary to eliminate the abuses described by the Treasury Department in its explanation of the proposal.

By way of background, sections 419 and 419A were enacted to limit certain abusive practices associated with the pre-funding of welfare benefits and generally limit such pre-funding, including severance and death benefits. Congress, however, permitted a limited exception to the general limitations for certain multiple employer welfare benefit funds with 10 or more participating employers where the relationship of participating employers would be closer to the relationship of insureds to an insurer than to the relationship of an employer to a fund.

This exception for ten or more employer plans under section 419A(f)(6) has the specific purpose of allowing small employers the ability to compete with larger employers in providing severance and death benefits to their employees. Major employers are able to fund such benefits on a pay-as-you-go basis because of their financial resources. Small employers do not have the cash resources to pay such benefits when they become due. In fact, because layoffs and terminations most often occur when there is a business slowdown—meaning cash flow or profits are not available—severance benefits are most important just at the time such employers are least likely to be able to pay for them. Thus, smaller employers were given the ability to fund such benefits in advance, when cash is available, in recognition that the cash to pay such benefits would likely be available to employers in the lean years.

Rather than curtailing the ability of smaller employers to continue to provide bona fide severance and death benefits to their employees by eliminating whole classifications of benefits, as the Administration's proposal would do, legislation if enacted should focus on the perceived abuses. In that regard, the major perceived abuse cited in the Treasury Department General Explanation of Revenue Proposals in the Clinton Administration FY2000 Budget is the requirement that to qualify as a ten or more employer plan under Section 419A of the Code, the plan must not be experience rated with respect to individual participating employers.

A plan may be deemed to be experience rated with respect to an individual employer because the employer (a) reaps the favorable economic consequences if its benefit costs are less than those assumed when the employer's premium was set, and (b) bears the economic risk that the benefit cost will exceed those assumed when the premium was set. Experience rating may reflect the employer's experience not only with regard to benefit payments, but also with regard to administrative costs or investment return. Thus, a plan provides an experience rating arrangement with respect to an employer if the employer's contributions are increased or decreased to reflect the benefit payments or administrative costs with respect to the employer's employees or the investment return with respect to the employer's contributions.

In *Robert D. Booth and Janice Booth v. Commissioner*, 108 T.C. No. 25 (1997), which was cited in the Treasury Department General Explanation, the Tax Court took the position that an experience rating arrangement may also include one where benefits rather than employer costs vary with fund experience. However, even under this definition of experience rating, gains or losses would still have to be segregated employer by employer for the plan to be experience rated with respect to individual participating employers.

It is true that some plans have attempted to disguise experience rating by creating reserve or other similar funds to which experience gains and losses are allocated. The final disposition of such experience gains and losses in such case is often unclear and a portion thereof may be allocated solely to the group of employees of a particular employer with respect to which the experience gain or loss relates. However, alleviating this problem can be accomplished without eliminating severance or death benefits funded with other than group term insurance.

This can be accomplished by first making sure that funding requirements in such plans are based solely on compensation, years of service, dates of employment, dates of birth, insurance risk classification and reasonable actuarial assumptions. Secondly, this can be accomplished by requiring that all experience as to benefit payments, forfeitures, investment returns, and administrative costs are allocated throughout the plan and the experience with respect to the employees of a particular employer are not segregated or allocated to that employer or its employee group. In addition, it could be required that all such experience gains or losses are allocated on an annual basis and not used to establish a reserve account. I would be happy to discuss these possible provisions with you further or suggest specific statutory changes if you wish.

In summary, the operation of welfare benefit plans under section 419A(f)(6) of the Code enables small employers to provide severance and death benefits to their employees by allowing them to fund such benefits in advance when profits are sufficient to do so. In no case are any funds paid into such a plan ever permitted to revert to the employer that contributed them. The Administration's proposed changes would eliminate the use of cash value insurance that provides sufficient funding to pay future mortality costs and severance benefits. Rather than eliminating such benefits, the Committee should attempt to find ways to expand the ability for employees to receive insured death and severance benefits while merely eliminating abuses that have occurred in certain cases. This can be done by more carefully drafting the rules with respect to experience rating as described above. As we have seen in the pension and other areas in the past, if benefits are taken away from business owners, the rank and file employees are more likely than not to receive no benefits at all.

We appreciate the Committee's attention and would be pleased to assist the Committee in resolving this important issue for the many thousands of small employers who rely in good faith on these plans to provide an important benefit to their employees.

Statement of Edison Electric Institute

The Edison Electric Institute (EEI) appreciates the opportunity to submit written comments to the Committee on Ways and Means regarding the Administration's FY 2000 revenue proposals.

EEI is the association of United States shareholder-owned electric companies, international affiliates and industry associates worldwide. Our U.S. members serve over 90 percent of all customers served by the shareholder-owned segment of the industry. They generate approximately three-quarters of all the electricity generated by electric companies in the country and service about 70 percent of all ultimate customers in the nation.

The 135 revenue proposals included in the Administration's fiscal year 2000 budget cover a broad range of topics, many of which are of interest to EEI. However, rather than comment on numerous provisions contained in the Administration's budget and potentially obscure the issues of critical importance to the electric industry, EEI will comment on three areas that are unique to the electric industry: fair competition between electric utilities, adequate funding of nuclear plant decommissioning, and the extension and modification of the production tax credit for wind and biomass facilities. EEI will also comment on the provisions dealing with tax shelters because this provision has the potential to adversely impact numerous taxpayers including shareholder owned utilities. EEI would be pleased to work with the Committee on any proposals that will be considered by the Committee for legislative action.

TREATMENT OF BONDS ISSUED TO FINANCE ELECTRIC OUTPUT FACILITIES

The electricity industry is shifting from regulation to the use of competitive markets to sell power and related services and products. For competition to work, the Federal government needs to address the artificial competitive advantages of tax-exemptions and tax-exempt financing used by government-owned utilities when competing against other sellers of electricity, so that all competitors can participate in open markets under the same set of rules.

Shareholder-owned and government-owned utilities grew up contemporaneously, but represented distinctly different approaches to providing electrical power. Shareholder-owned utilities started out as entrepreneurial businesses mainly serving towns and cities and they were taxed like any other business. By contrast, government-owned utilities came into their own during the 1930s, when only about 15 percent of small-town America had access to electricity. Tax-exemptions and other kinds of government subsidies were used to finance electrification in an attempt to break the grip of the Great Depression. Today, 99 percent of America is electrified.

Up to now, the two systems have lived side-by-side serving customers in their geographically defined service areas. The different tax treatment of the two types of utilities creates profound problems when they compete in open markets. In order for competition to work well, the marketplace, and not tax law, must determine the outcome. In a competitive marketplace, providing some competitors with federal tax subsidies in the form of exemption from income tax and the ability to finance facilities using tax-exempt debt, merely because they are instruments of State or local governments, can alter the competitive outcome and result in a misallocation of societal resources. The Council of Economic Advisers stated in the "Economic Report of the President" (Transmitted to Congress February 1996) on pages 188–189 that:

> "For competition to work well, it must take place on a level playing field: competition will be distorted if producers are given selective privileges ... to further even legitimate social goals. ... As competition grows, increasing distortions may result from some entities having access to special privileges such as federally tax-exempt bonds ..."

When these tax-exemptions and tax-free bonds are used in competitive markets, they act as subsidies that undermine competition. As competitive markets are beginning to form, now is the time to address the problem.

The Administration's Proposal

EEI supports the Administration's approach to addressing this problem in that it acknowledges the need to change current tax law to reflect the move to a competitive industry. It does so by stipulating that no new facilities for electric transmission or generation may be financed with tax-exempt bonds. This represents a good start from which to resolve these important issues.

Congressional Proposals

EEI strongly believes that there is no essential governmental purpose served when a governmental utility goes outside its service territory and sells output into areas in which it has no legitimate governmental interest. Rather, such a governmental utility is acting as a commercial entity and should be treated as such. It should no longer be able to issue new tax-exempt debt to finance power plants or transmission facilities, and it should be subject to Federal income tax on the income from the sales it makes to persons outside its historical service area. Legislation accomplishing this objective will be introduced this month by Representative Phil English. EEI strongly supports this legislation and encourages the Committee on Ways and Means to consider it during its deliberations on a tax bill this year.

Legislation (H.R.721) also has been introduced that would *broaden* the ability of government-owned utilities to leverage their tax preferences to compete against taxpaying utilities. It would allow government-owned utilities to sell power from federally subsidized facilities to customers outside their existing service territory without paying income tax on profits from those sales. It would considerably broaden the ability of government-owned utilities to build new transmission facilities with tax-exempt bonds, facilitating *government* control of transmission as the industry deregulates. EEI, therefore, opposes this bill as it runs contrary to both the English and Administration proposals.

TREATMENT OF CONTRIBUTIONS TO NUCLEAR DECOMMISSIONING TRUSTS

Code Section 468A allows a special rule for the future costs of decommissioning nuclear power plants. A current deduction is allowed for contributions to a qualified external trust fund ("Fund"), the net assets of which are to be used exclusively to provide for the safe and timely decommissioning of a taxpayer's nuclear plant.

As Code Section 468A was being considered in 1984, Congress was concerned about time value of money advantages then described as "premature accruals." Nuclear plant decommissioning involves a significant fixed liability that, in a regulated environment, is ideally suited for funding during the operating life of the plant. Funding in this manner assures that the electric customers that receive the electricity from the plant also pay their ratable share of the decommissioning costs. Safe and environmentally acceptable decommissioning was considered of sufficient national importance to warrant a special tax deduction. Congress did not intend that this deduction would lower the taxes paid by the owner of a nuclear plant in present value terms. The time value of money concern was redressed by requiring that the income earned by the Fund be taxed as it is earned and also taxed a second time when the trust's funds are withdrawn by the plant owner to pay decommissioning costs.[1]

The original intent of Congress was to spread the deduction of decommissioning costs over the *operating* life of the plant and also to facilitate the creation of a dedicated external trust fund.[2] This was accomplished with Section 468(A) which facilitates contributions to an independent trust to provide reasonable assurance that the amounts will be available to pay for the costs of decommissioning. We believe the current circumstances have changed considerably and current provisions of 468(A) are no longer pertinent nor appropriate.

In addition to imposing a double tax on earnings, Congress imposed limits: (1) to prevent the accumulation of more monies in a Fund than are required to fund the portion of future decommissioning costs allocable to the remaining plant life, and (2) to ensure that contributions to the reserve are not accelerated.

In an era in which the remaining lives of many nuclear plants are being revised downward, restrictions that are based upon concerns over accumulating more funds than are required or accelerated funding are no longer well-founded. The important national concern is that funds will be available when needed to pay the costs of decommissioning. In fact, the limitations that restrict the annual amount of qualified contributions could serve as a deterrent to the transferability of the ownership interest in the nuclear plants or in the deregulation of the electric generation. Proper tax and public policy should be to allow a tax deduction for nuclear decommissioning when the net present value of the decommissioning liability is contributed to the independent trust fund. For this reason, EEI strongly believes that the purposes of these limits are no longer appropriate due to changes in the electric industry.

In addition, Congress required that the contribution to the Fund be paid only from monies, collected under regulatory authority, from customers for that specific purpose. As generating plants are deregulated this limitation may have the unintended effect of prohibiting deductions for funding decommissioning. Put another way, no regulatory authority, no deduction. The Administration is to be commended for proposing the repeal of this limitation.

ENERGY AND ENVIRONMENTAL TAX PROVISIONS

As producers of electricity and processors of the earth's finite fuels, electric utilities continue to support the use of tax credits to sponsor both the efficient uses of electricity and the generation of electricity from wind or biomass.

Wind

The production tax credit (PTC) for wind (and closed-loop biomass) facilities will expire on July 1, 1999. To promote the continued development of wind energy production in the United States, the Administration's budget includes a five-year extension of the PTC. The credit provides an inflation-adjusted 1.5 cents/kilowatt-hour credit for electricity produced from a new U.S. wind facility for the first ten years of its existence. The credit is only available if the wind energy equipment is located in the U.S. and electricity is generated and sold in the marketplace.

The PTC assists wind-generated energy in competing with fossil fuel-generated power. In the 1980's electricity generated with wind could cost as much as 25 cents/kilowatt-hour. Since then wind energy production has increased its efficiency by a remarkable 80% to the current cost of under 5 cents/kilowatt hour. The current 1.7 cents/kilowatt-hour credit enables the industry to compete with other generating sources being sold within the range of 3 cents/kilowatt-hour. The extension of the credit will enable the industry to continue to develop and improve its technology so it will be able to fully stand on its own in only a few years. Indeed, experts predict the cost of wind equipment alone can be reduced by another 40% from current levels with an appropriate commitment of resources to research and development. This is exactly what Congress envisioned when it enacted the PTC, the development and improvement of wind energy technology.

The immediate extension of the PTC is critical. Since the PTC is a production credit available only for energy actually produced from new facilities, the credit is inextricably tied to the financing and development of new facilities. The financing and permitting requirements for a new wind facility often require up to three or more years of lead-time. With the credit due to expire on June 30, 1999, wind en-

[1] The fund is, in fact, a grantor trust for all purposes save federal tax purposes. Section 468A(e)(2) taxes the fund as if it were a corporation. However, in the case of a normal grantor trust, previously taxed income would not be treated as income again as funds are withdrawn.

[2] 1984 Tax Reform Act, Legislative Background of Senate Finance Committee Deficit Reduction Provisions, pages 277–9.

ergy developers and investors can not plan any new projects without the assurance of the continued availability of the PTC. The immediate extension of the PTC is therefore critical to continued development of the wind energy market.

The Administration is to be commended for its commitment to promote the continued development and improvement of wind energy technology. At this stage of development, wind power is unable to compete head to head with traditional electric generation. The potential for further improvement exists and it is therefore prudent to encourage development of this industry with the extension of the PTC.

Biomass

The purpose of the closed-loop biomass credit is to provide an incentive for locking carbon into plant cellulose material temporarily, which reduces carbon dioxide's effect on global warming.

The present biomass credit, which requires that the crop must be raised for the *exclusive* use of producing electricity, has not been effective. To our knowledge there is not one facility in the nation that has been able to take advantage of this credit.

However, electricity from crop by-products can accomplish essentially the same purpose. Natural decomposition of forest and agricultural by-products produce greenhouse gasses such as methane in addition to carbon dioxide. Using forest or agricultural by-products to produce electricity would serve the dual role of reducing the use of irreplaceable fossil fuel, allowing fossil fuel carbon to remain trapped, and the conversion of otherwise wasted biomass products to valuable fuel. The proposed definition allowing forest and agriculture by-products to qualify as creditable biomass would provide the needed economic stimulus that was originally intended for the closed-loop biomass credit. EEI, therefore, believes that the broadened definition of biomass fuel and the extension of the tax credit are required steps to increase electric generation from this fuel source.

UNDERSTATEMENT PENALTY FOR "CORPORATE TAX SHELTERS"

EEI believes that proposed modifications to the understatement penalty which proposes an automatic 40% penalty based upon an overly broad and vague definition of "corporate tax shelter" will cause major problems and interfere with legitimate transactions. The 40% penalty question turns on whether the arrangements of corporate affairs so that taxes would be as low as possible were "clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code.)"

The clearly contemplated Congressional purpose of the provisions of the Internal Revenue Code is currently the topic of discussion at innumerable IRS Appellate hearings and court cases. If the actual results of the IRS administrative appeals process as reported by the General Accounting Office and court case results of our members are valid indications of what Congress clearly intended, the statistics demonstrate that the disputed adjustments of the IRS agents are incorrect 80% of the time.[3] The record of the IRS Agents demonstrates that when it comes to determining what is the clearly contemplated Congressional purpose for such provision, the clear intention appears to be more apparent to the corporate tax professionals than IRS tax professionals.

Complex tax law will result in legitimate differences of opinion. Different minds do understand the facts and the law differently. Corporate tax professionals and IRS tax professionals can deal within this technical realm, and the substantial tax dollars and interest dollars in the balance. The injection of a penalty into this situation is an altogether different matter. A penalty, especially a penalty of this magnitude, calls into question the honesty of the corporate tax professionals and the corporate officers. The Administration is proposing to inject a punishing 40% penalty for misinterpreting the Congressional purpose without any consideration of a determination, made contemporaneously with the decision to enter into the transaction, that the position taken was more likely than not to prevail and without consideration of any reasonable cause.

The proper forum for dispute resolution is one that focuses on the merits of the issue and the plain meaning of the law which the penalty provision makes infinitely more complex. The 40% nondeductible provision will lead to deep seeded taxpayer resentment of the tax system. The national system of taxation will not be improved by the addition of a 40% penalty, based upon the subjective opinion of the taxing authority, as to whether or not a transaction was entered into for the purpose of

[3] GAO/GGD–98–128 IRS Audit Results and Cost Measures Coordinated Examination Program results, Table 2, page 10.

keeping taxes as low as possible within the clearly contemplated Congressional purpose.[4]

CONCLUSION

EEI believes that a level playing field is essential for efficient competition in the electric industry. Although the Administration has proposed to reduce the prospective subsidies received by governmental utilities through tax-exempt financing, the Administration has not addressed their exemption from income tax. EEI recommends that the Committee should disallow the use of tax-exempt financing for government owned utilities which choose to sell more than a de minimus amount of electricity outside their municipal boundaries.

EEI supports the Administration's proposal to repeal the cost of service requirement for contributions to a qualified nuclear decommissioning fund. In addition, EEI believes that the qualifying percentage and the limitation based on ruling amounts should also be repealed.

EEI supports the Administration's proposal for the five-year extension of the production tax credit for wind and biomass facilities.

EEI also is concerned about the broad definition of an improper corporate tax shelter and the unfavorable effect it will have on our tax system.

Statement of Employer-Owned Life Insurance Coalition

This statement presents the views of the Employer-Owned Life Insurance Coalition, a broad coalition of employers concerned by the provision in the Administration's fiscal year 2000 budget that would increase the taxes of leveraged owners of life insurance policies.

CONGRESS SHOULD REJECT THE ADMINISTRATION'S LIFE INSURANCE PROPOSALS

The Administration's fiscal year 2000 budget proposal would increase taxes of highly-leveraged taxpayers that purchase life insurance. Businesses purchasing insurance on the lives of their employees would be denied a portion of the deduction to which they are otherwise entitled for ordinary and necessary interest expenses unrelated to the purchase of life insurance. The Administration's characterization of this proposal as eliminating a "tax shelter" obscures the real goal of this proposal, which is to tax the accumulated cash value, commonly known as "inside buildup," within these policies.

Congress has consistently refused to tax inside buildup and, for the reasons set forth below, we urge Congress to reject this ill-conceived proposal as well.

DISGUISED ATTACK ON HISTORICAL TREATMENT OF TRADITIONAL LIFE INSURANCE

The Administration's proposal drives at the heart of permanent life insurance. Although the Treasury Department has characterized the proposal as preventing "tax arbitrage," *the proposal in reality targets the very essence of traditional permanent life insurance*: the inside buildup. The Administration's proposal would impose a new tax on businesses based on the cash value of their life insurance policies.

The Administration's proposal would deny a portion of a business's otherwise allowable interest expense deductions based on the cash value of insurance purchased by the business on the lives of its employees. Though thinly disguised as a limitation on interest expenses deductions, the proposal generally would have the same effect as a tax on inside buildup. Similar to a tax on inside buildup, the interest disallowance would be measured by reference to the cash values of the business's insurance policies—as the cash values increase the disallowance would increase, resulting in additional tax. So while not a direct tax on inside buildup, the effect would be similar—accumulate cash value in a life insurance policy, pay an additional tax.

HISTORICAL TAX TREATMENT OF PERMANENT LIFE INSURANCE IS SOUND

The Administration's proposal would change the fundamental tax treatment of traditional life insurance that has been in place since the federal tax code was first enacted in 1913. Congress has on a number of occasions considered, and each time

[4] We also agree with Judge Learned Hand who stated, "There is nothing sinister in so arranging one's affairs to keep taxes as low as possible."

rejected, proposals to alter this treatment. In fact, just last year, Congress rejected a number of proposals, including the proposal now under consideration, to tax inside build up. Nothing has changed that would alter the considered judgment of prior Congresses that the historical tax treatment of traditional life insurance is grounded in sound policy and should not be modified.

Among the reasons we believe that these latest attacks on life insurance are particularly unjustified, unnecessary and unwise are—

Cash Value is Incidental to Permanent Life Insurance Protection

The cash value of life insurance is merely an incident of the basic plan called "permanent life insurance" whereby premiums to provide protection against the risk of premature death are paid on a level basis for the insured's lifetime or some other extended period of years. In the early years of a policy, premiums necessarily exceed the cost of comparable term insurance. These excess premiums are reflected in the "cash value" of the policy. As fairness would dictate, the insurance company credits interest to the accumulated cash value, which helps finance the cost of coverage in later years, reducing aggregate premium costs.

Thus, while a permanent life insurance policy in a sense has an investment component, this feature is incidental to the underlying purpose of the policy. The essential nature of the arrangement is always protection against the risk of premature death. For businesses, life insurance protects against the economic devastation that can occur with the death of an invaluable employee or the business owner. Life insurance is a cost-effective way to obtain this protection because the costs for life insurance do not increase as the covered individual ages.

While some might conclude that only small businesses need the stability provided by permanent life insurance, this is not in fact true. All corporations are susceptible to catastrophic economic losses resulting from the death of an invaluable employee. Large corporations use permanent life insurance to protect against, and level out the costs associated with, the economic uncertainty the possibility of such future losses creates. The United States Court of Appeals for the Seventh Circuit,[1] discussing why corporations purchase liability insurance, noted that:

> Corporations . . . do not insure to protect their wealth and future income, as natural persons do, or to provide income replacement or a substitute for bequests to their heirs (which is why natural persons buy life insurance). Investors can "insure" against large risks in one line of business more cheaply than do corporations, without the moral hazard and adverse selection and loading costs: they diversify their portfolios of stock. Instead corporations insure to spread the costs of casualties over time. Bad experience concentrated in a single year, which might cause bankruptcy (and its associated transaction costs), can be paid for over several years.

A regular, level, predictable life insurance premium replaces the uncertainty of large, unpredictable losses caused by the death of such an employee. This predictability frees all corporations to make long term plans for business development and growth.

The Tax Code Already Strictly Limits Cash Value Accumulations

The Administration's proposal ignores the major overhauls of life insurance taxation made by Congress over the past 20 years. These reforms have resulted in a set of stringent standards that ensure that life insurance policies cannot be used to cloak inappropriate investments.

The most significant reforms occurred in the 1980's, when Congress and the Treasury undertook a thorough study of life insurance. It was recognized that while all life insurance policies provided protection in the event of death, some policies were so heavily investment oriented that their investment aspects outweighed the protection element. After much study, Congress established stringent statutory guidelines, approved by the Administration, that limit life insurance tax benefits at both the company and policyholder levels to those policies whose predominant purpose is the provision of life insurance protection.

- In 1982, Congress first applied temporary "guideline premium" limitations to certain flexible premium insurance contracts;
- In 1984, Congress revised and tightened these limitations and extended them to all life insurance products;
- In 1986, the Congress again reviewed these definitional guidelines, making additional technical and clarifying changes;

[1] Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 862 (7th Cir., 1992)

• Finally, in 1988, the Congress again addressed these issues, developing still more restrictive rules for certain modified endowment contracts and modifying the rules applicable to life insurance contracts to require that premiums applicable to mortality charges be reasonable, as defined by Treasury regulation.

Today, these guidelines (set forth in sections 7702 and 7702A of the Internal Revenue Code) significantly limit the investment element of any policy by requiring specific relationships between death benefits and policy accumulations under complicated technical rules (the so-called cash value test or the guideline premium/cash value corridor tests). *Policies that cannot meet these limitations were deemed "investment oriented" in the judgment of Congress and are not eligible for tax treatment as life insurance*.

On the other hand, Congress and the Administration clearly intended that inside buildup within policies *satisfying* the new criteria would *not* be subject to taxation. In fact, policymakers concluded that with the tightening of the definition of life insurance and the placing of narrower limits on the investment orientation of policies, there was all the more reason for continuing an exemption for inside buildup. Buck Chapoton, then Assistant Secretary of the Treasury for Tax Policy testified on this point before a Ways & Means subcommittee in 1983, explaining that:

> the treatment of [inside buildup bears] an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the [inside buildup] under policies that fall under a tighter definition. [Tax Treatment of Life Insurance; Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 10, 1983, 98th Cong., 1st Sess. 16 (1983).]

Congress proceeded on this basis and, as noted above, in 1984 established a tighter and narrower definition of life insurance.

In addition to blessing the continuation of tax benefits for inside buildup within life insurance contracts when it considered these issues in the 1982, 1984, 1986 and 1988 legislation described above, Congress did so on numerous other occasions by failing to enact Treasury proposals to tax inside buildup. For example, notwithstanding Treasury proposals to tax inside buildup contained in the 1978 Blueprints for Tax Reform, the November, 1984 Treasury Tax Reform proposals, the 1985 Tax Reform Proposals and various budget proposals in the 90's, Congress consistently refused to tax inside buildup within life insurance policies.

The Tax Code Already Prevents Abusive Leveraging of Life Insurance

Businesses purchasing life insurance policies that satisfy the rigorous life insurance qualification tests are still further restricted in the funding and use of those policies. Since 1964, the Internal Revenue Code has denied interest deductions on Loans traceable to the acquisition or holding of a life insurance policy. However, Congress has always distinguished between the perceived abuses of life insurance and the legitimate use of life insurance.

Congress has implicitly endorsed continuation of inside buildup in each of the past three years while addressing specific perceived abuses. In 1996 it considered and addressed certain perceived problems with policy loans by repealing the deduction for interest on policy loans. However, no attempt was made to tax inside buildup generally.

In 1997, Congress became concerned that Fannie Mae intended to use its quasi-federal status and preferred borrowing position to purchase coverage for its customers (denying a portion of Fannie Mae's otherwise applicable interest deductions). When drafting the interest disallowance, Congress distinguished its concerns regarding what was considered to be Fannie Mae's inappropriate efforts to exploit its preferred borrowing position from the typical situation involving employer-owned policies. As a result, Congress provided a clear exemption for policies purchased by a business on employees, officers, directors and 20-percent owners.

Finally, just last year Congress rejected the same indirect attack on inside buildup the Administration proposes again this year. In the same year, however, Congress again demonstrated its commitment to preserving tax-favored status for employer policies by enacting additional technical corrections to clarify the scope of the exemption enacted in 1997 (e.g. to cover former employees, group contracts, etc.).

In 1998, the Administration's fiscal year 1999 budget also contained direct assaults on the tax preferred status of inside build up in proposals designed to tax inside build up in certain policy changes and transactions involving insurance company separate accounts as well as through adjustments to annuity basis rules. These proposals were widely criticized, and Congress rejected all of them. This year, the Administration has abandoned this direct attack in favor of an indirect taxation of inside buildup.

In each of the past three years, Congress was asked to address concerns over perceived exploitation of certain tax benefits related to life insurance. It had the opportunity to impose sweeping, across the board changes to the traditional taxation of life insurance policies. Congress rejected this course, choosing instead to pursue a reasoned middle course. Legislation was crafted to narrowly address specific concerns without trimming any of the core tax benefits afforded with respect to inside buildup.

Given this detailed review of life insurance policies, employers reasonably relied on the continued availability of inside buildup with respect to the policies they previously held, as well as in subsequent policy purchases. Similarly, carriers reasonably relied on the continued availability of inside buildup in developing and marketing insurance policies. Treasury's attempt, once again, to reverse Congress's well reasoned decision is unconscionable. For yet another year, policyholders and carriers made business decisions in reliance on congressional decisions and are again thrown into turmoil as a result of the Administration's thinly disguised attack on inside buildup. Consistent with every prior, Congressional decision on this issue, this proposal must AGAIN be summarily rejected.

Purchase of Life Insurance Has Recognized, Legitimate Business Purposes

In re-proposing this disallowance, the Administration has attempted to shift Congressional attention away from the proposal's unstated goal of taxing the inside buildup by labeling the proposal, not as a proposed insurance tax modification as it did last year, but as a corporate tax shelter. Nothing has changed in the proposal from last year to this year except the packaging. The proposal is still just an attack on inside build up—it is not an attempt to eliminate a tax shelter because no tax shelter exists.

The Administration would have you believe that every business purchasing life insurance is engaging in tax arbitrage if that business is or becomes leveraged. It is irrelevant under the Administration's proposal that the debt was acquired at a different time, or that the business had distinctly separate, but equally valid, non-tax business reasons for acquiring a life insurance policy and incurring debt. The purchase of a life insurance policy will "taint" previously, legitimately acquired debt, and the existence of a life insurance policy will "taint" any debt acquired after the life insurance policy is purchased.

Legitimate business purposes exist for purchasing life insurance. Similarly, businesses incur debt for equally valid business reasons. But there is no room in the Administration's proposal to recognize the potentially valid reasons for engaging in two unrelated transactions. This approach completely disregards Congress's longstanding respect for and support of, debt-financed transactions and the purchase of life insurance by businesses.

APPRECIATION IN CASH VALUE SHOULD NOT BE TAXED

Long-Term Investment Should be Encouraged, Not Penalized

Permanent life insurance provides significant amounts of long-term funds for investment in the U.S. economy. These funds are attributable to *permitted* levels of policy investment. Businesses acquire life insurance policies to provide protection against the death of a valued employee or owner as well as a funding vehicle for many employee benefits, often including retiree benefits. These reasons for purchasing and maintaining life insurance policies benefit the U.S. economy. By ensuring that fewer businesses fail due to the death of an invaluable individual other employees are still employed. By funding employee benefits, more active employees and retirees are provided for, which reduces the strain on public benefits.

The incidental investment element inherent in permanent life insurance should, if anything, be encouraged, not penalized. Congress and the Administration have repeatedly emphasized the need to increase U.S. savings, especially long term and retirement savings. Recent efforts have used the tax code to *encourage* savings, not penalize them. Consider, for example, the recent expansion of IRAs, the introduction of Roth IRAs and education IRAs, as well as small employer savings vehicles like the SIMPLE. Given these savings goals, the Administration proposal to significantly reduce or eliminate business's efforts to fund long-term employee benefits and retirement savings programs for their employees appears especially misguided.

Unrealized Appreciation Should Not be Taxed

There is another, more fundamental, reason why the incidental investment inherent in permanent life insurance should not be taxed currently: accumulating cash values represent unrealized appreciation. Taxing a business currently on the increase in the cash value of a life insurance policy would be like taxing a homeowner each year on the appreciation in value of the home even though the home has not been sold. This would be inconsistent with historical and fundamental concepts of the federal income tax and contrary to the traditional principle that the government should not tax unrealized amounts which taxpayers cannot receive without giving up important rights and benefits. Taxing life insurance policyholders on accumulating cash values would single out life insurance by withdrawing the protection generally provided against taxation of an amount the receipt of which is subject to substantial restrictions. Given that much of this "investment" actually reflects a prepayment of premiums designed to spread costs levelly over the insured's life, this would be especially inappropriate.

Ordinary and Necessary Interest Expenses Should be Deductible

The Administration's proposal to disallow otherwise deductible interest expenses is inconsistent with fundamental income tax principles.

Interest Payments are an Ordinary and Necessary Business Expense

It is difficult to comprehend how an otherwise ordinary and necessary business expense loses its status as such solely because a business purchases life insurance on its employees. For example, few would argue that if Acme Computer borrows funds to help finance the cost of a new supercomputer assembly plant, the interest Acme pays on the debt is a legitimate business expense that is properly deductible. How can it be that if Acme decides it is prudent to purchase life insurance on the leader of the team that developed the supercomputer—to help offset the inevitable transition costs that would follow the team leader's unexpected death—that a portion of the interest payments is suddenly no longer considered a legitimate business expense? This is precisely the effect of the Administration's proposal.

To fully appreciate this provision, apply the underlying rationale to an individual taxpayer: Should any homeowner who purchases or holds life insurance be denied a portion of the otherwise applicable deduction for mortgage interest? Or, carrying the analogy a bit further, should any homebuyer who contributes to an IRA or a section 401(k) plan (thereby receiving the tax benefits of tax deferral or, in the case of a Roth IRA, tax exemption) be denied a portion of the otherwise applicable deduction for mortgage interest?

The Treasury Department asserts that the deduction denial would prevent tax arbitrage in connection with cash value policies. However, the proposal does not apply to debt directly or even indirectly secured by cash values; interest on such amounts is nondeductible under current law. Section 264 of the Internal Revenue Code disallows a deduction for interest on policy loans from the insurer as well as on loans from third parties to the extent the debt is traceable to the decision to purchase or maintain a policy. Thus, the only interest deductions that would be affected by the proposal would be those attributable to unrelated business debt—loans secured by anything but life insurance. The arbitrage concern is a red herring; the real target is inside buildup.

If the Administration has concerns about the insurance policy purchased on the life of the team leader, then it should say so—and it should address the issue directly. It is inappropriate to deny instead a legitimate business expense deduction as an indirect means of taxing inside buildup. Congress, for sound policy reasons, has steadfastly refused to enact proposals that more directly attack inside buildup; it should similarly refuse to enact this proposal.

Disproportionate Impact on Similar Businesses

The Administration's proposal to impose a tax penalty on businesses that purchase life insurance on their employees would have a disproportionate impact on highly-leveraged businesses. For financial institutions that are generally highly-leveraged because assets of their customers are generally viewed as debt of the institution, the effects of the proposal would be disproportionately harsh. This is inconsistent with a fundamental tenet of the tax laws that, to the extent possible, taxation should be neutral with respect to core business decisions such as the appropriate degree of debt. It is also patently unfair and without policy justification.

To illustrate the disproportionate burden on highly-leveraged businesses, take the following example: Assume two competing companies, each with $50 million in assets. Company A has $2 million in outstanding debt, with an annual interest expense of $150,000. Company B has $20 million in outstanding debt, with an annual interest expense of $1.8 million.

If Company A purchases an insurance policy on the life of its resident genius, Company A would be required to forego a portion of the interest expense on its outstanding debt. For example, if the cash value of the policy were $5 million, one-tenth of the annual interest expense, or $15,000, would not be deductible.

If Company B buys the same policy for its resident genius, it too would be required to forego one-tenth of its interest expense deduction. However, for Company B, this amounts to a foregone deduction of $180,000—*12 times the amount foregone by Company A*.

The deduction disallowances illustrated above would occur *each year*, compounding the disproportionate impact on Company B. Over a span of 30 years, Company B could lose interest deductions in excess of $5.4 million—while Company A might lose closer to $450,000.

Whatever one's beliefs about the proper tax treatment of life insurance policies, what possible justification exists for imposing a tax penalty associated with the purchase of such a policy that varies with the level of a company's outstanding debt?

CONCLUSION

For the reasons explained above, we believe the Congress, consistent with its long-standing interest in preserving tax benefits for inside buildup within life insurance contracts, should reject the Administration's insurance proposal, which would effectively subject inside buildup to current taxation.

Statement of Equipment Leasing Association, Arlington, Virginia

INTRODUCTION

The Equipment Leasing Association is submitting this statement for the record to express our concerns regarding the proposed "corporate tax shelter proposals" included in the Clinton Administration's proposed FY 2000 Budget. ELA has over 800 member companies throughout the United States who provide financing for all types of businesses in all types of markets. Large ticket leasing includes the financing of transportation equipment such as aircraft, rail cars and vessels. Middle market lessors finance high-tech equipment including main frame computers and PC networks, as well as medical equipment such as MRIs (magnetic resonance imaging) and CT (computed tomography) systems. Lessors in the small ticket arena provide financing for equipment essential to virtually all businesses such as phone systems, pagers, copiers, scanners and fax machines.

WHAT TYPE OF COMPANY LEASES?

More companies, particularly small businesses, acquire new, state of the art equipment through leasing than through any other type of financing. Eighty percent of all U.S. companies lease some or all of their equipment. Companies that lease tend to be smaller, growth-oriented and focused on productivity—these are companies long on ideas, but often, short on capital.

WHY COMPANIES LEASE

Companies choose lease financing for several reasons:

- Leasing permits 100% financing;
- Leasing permits a close matching of rental payments to the revenue produced by the use of the equipment;
- Leasing allows companies to keep their debt lines open for working capital rather than tying it up in capital expenditures;
- Companies that lease know that they make money by using the equipment, not owning it;
- Leasing allows a company to focus on its core business—they don't have to worry about maintenance, upgrading or asset disposition;
- Leasing minimizes concerns about the technological obsolescence of the company's equipment;
- Leasing shifts asset management risk to the lessor, away from the user.

Leasing by commercial enterprises increases productivity and stimulates economic growth. While the federal and state tax codes provide various incentives to invest in new equipment, many companies find they are not in a financial position to utilize the incentives. However, through leasing, the intended incentives to invest can be passed through to the company using the equipment in the form of lower rental payments because the leasing company utilizes the intended investment incentives. The use of leasing in this manner has long been intended by Congress.

LEASING CREATES JOBS

It is estimated that each increase of $1 billion in equipment investment creates approximately 30,000 jobs (Brimmer Report). According to the U.S. Department of Commerce, in 1998 alone, the equipment leasing industry financed over $183 billion in equipment acquisition and it is anticipated that equipment lessors will finance over $200 billion in new equipment acquisition in 1999.

STATE AND LOCAL GOVERNMENTS LEASE, TOO

It is not only commercial enterprises that lease equipment. Tax-exempt entities such as states, cities, counties and other subdivisions around the U.S. often lease various types of equipment in an effort to keep taxpayer costs down. Equipment leased by local governments includes 911 emergency phone systems, computers, school buses and police vehicles. Tax-exempt hospitals often lease their emergency vehicles and high-cost, sophisticated diagnostic medical equipment, in an effort to keep health care costs down.

Lessors also lease equipment to other tax-exempt entities such as foreign corporate enterprises or individuals. Examples include automobile fleet leasing, leases of tractors and trailers, and leases of aircraft (both commercial and corporate). Further, many domestic lessees have the right to sublease assets into foreign markets in times when the equipment may be surplus. Very often, these subleases are to entities in foreign markets which have the need for the asset

THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS REPRESENT A SIGNIFICANT CHANGE IN U.S. TAX POLICY

An analysis of the Administration's sweeping and vague corporate tax shelter proposals raises the concern that leasing transactions which conform to long standing tax policy and Congressional intent could be negatively impacted by the Administration's proposals. If this were the case, these proposals would represent a significant change in longstanding U.S. tax policy. Treasury officials have advised us that it is generally not their intent to negatively impact lease finance structures, and that this would be clarified in their anticipated "white paper." Without this clear exclusion of leasing transactions that meet the standards of current law from the sweeping new corporate tax shelter proposals, ELA must oppose these proposals and urges Congress to reject them.

ELA has long supported two fundamental principles of federal tax policy. First, the form of financing chosen to facilitate the acquisition of assets, whether loans or leases, should be respected as long as economically valid. Second, the principle that the tax treatment of an owner of an asset should not differ whether the asset is used directly by the owner or leased to another end-user. Again, in their current form, the Administration's proposals appear to violate these two principles and have already had a chilling effect on equipment acquisition in certain markets. Therefore, ELA opposes them and urges Congress to reject them.

FURTHER LIMITING LESSORS' TAX BENEFITS IN TAX-EXEMPT USE PROPERTY TRANSACTIONS IS WRONG !

ELA has grave concerns regarding the scope of the Administration's proposal to "Limit Inappropriate Tax Benefits For Lessors of Tax-Exempt Use Property." While Treasury has expressed concerns regarding one specific type of cross-border financing structure—the "lease-in/lease-out" ("LILO") structure—the Administration's legislative proposal would impact virtually every cross-border transaction with a tax-exempt entity. The proposal may also impact domestic lease transactions wherein the lessee may be able to sublease the equipment to a foreign user at some point during its life. (A tax-exempt entity includes the United States, State or local governments, tax-exempt organizations, and any foreign person or entity (Section 168(h)(2)).

Under current law, lessors of "tax-exempt use property" are already penalized, as they are limited in their ability to claim certain tax benefits. Lessors of tax-exempt use property are prohibited from using either an accelerated method of depreciation or economic depreciation if the lease term is equal to or greater than an asset's class life. Instead, they are required to use a straight-line method over a recovery period that is not less than 125% of the lease term.

The Administration's proposal would further inhibit lease financing, as it would generally prohibit a lessor of property leased to a foreign lessee (as well as other tax-exempt persons) from currently utilizing net losses from a leasing transaction. Instead, to the extent a lessor of tax-exempt use property realizes in any year a net loss, the net loss would be suspended and carried forward to offset the future income from the transaction. This proposal would eliminate all of the tax deferral benefits that underpin the economics of cross-border leasing.

Every lease transaction generates deductions in the early years of the transaction, which are offset by the taxable income in the later years. It is the U.S. lessor's ability to use these deductions against its other business income that allows it to provide the lessee with a lease rate that is lower than a straight borrowing. If enacted, this proposal will have a devastating impact on U.S. companies currently involved in selling assets to foreign entities where lease financing has been a significant feature of the marketplace, for example, manufacturers of aircraft and aircraft engines. As such, the proposal is contrary to long-established policies of promoting U.S. exports. (The proposal could also negatively impact U.S. domestic leasing by inhibiting flexibility of use and subleasing of the asset).

Clearly, the Administration's proposal goes far beyond what is necessary to prevent perceived abusive transactions as it encroaches upon non-abusive transactions that are permitted under current law. In fact, in light of the 1986 depreciation rules providing for straight-line depreciation over the class-life of foreign use property (which were intended to replicate economic depreciation), we believe that the Pickle depreciation rules, insofar as they relate to foreign lessees, are no longer necessary or appropriate and do not reflect sound tax policy. Consequently, we urge Congress to reject this proposal and encourage the Treasury Department to support a depreciation rule which does not discriminate between property owned by a U.S. taxpayer that is used outside the U.S. and property owned by a U.S. taxpayer that is leased to a foreign person. In both cases the income is fully taxable.

TREASURY HAS SUFFICIENT AUTHORITY UNDER CURRENT LAW TO ADDRESS FINANCING STRUCTURE CONCERNS

It is clear that Treasury has authority under current law to shut down the "lease-in/lease-out" ("LILO") transactions that it opposes (see Revenue Ruling 99–14). Instead of advancing an overly broad legislative proposal which will disrupt efficient, economic-based transactions, we once again call upon Treasury to exercise its existing authority under current law to address its specific concerns and issue final 467 regulations, which have been pending in proposed form for over two years.

The Administration's proposal is also overly broad in that it could inappropriately affect legitimate business deductions that may be tangentially related to a leasing transaction but are not generated to shelter income. This legislation is not needed. A much narrower solution for addressing Treasury's concerns regarding "LILOs" is available—the issuance of final Section 467 regulations.

We also believe that the Administration's proposal is in direct conflict with the Congressional objective of developing a U.S. trade policy which will provide U.S. companies with the ability to compete on a level playing field with their foreign competitors. If enacted, this legislation will severely inhibit the ability of U.S. exporters and financial institutions to compete effectively on a global scale. If U.S. companies are not able to compete on cross-border leases, tax revenues currently going to the U.S. Treasury will be lost to foreign Treasuries, as all leases, including cross-border leases, generate more taxable income than deductions over the life of the lease agreement.

PROPOSAL TO "DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS" WILL INCREASE STATES' AND MUNICIPALITIES' COST OF CAPITAL

ELA opposes the Administration's proposal to "disallow interest on debt allocable to tax-exempt obligations," as the elimination of the 2% de minimis rule will impair the ability of state and local governments to raise capital. While non-financial corporations may not account for a large percentage of total municipal securities outstanding, these corporate buyers do play a vital role in three important market segments: 1) short term municipal investments, 2) state and local government housing and student loan bonds, and 3) municipal leasing transactions.

CONCLUSION

The uncertainty caused by the Administration's proposals has already had a chilling effect on equipment acquisitions in various markets. For over three decades, ELA members have provided lessees with various lease financing options which conform to long standing tax policy and Congressional intent. Taxpayers ask, "at what point did Congressionally-intended incentives for investment and economic growth become 'abusive corporate tax shelters'?"

Congress, the Treasury Department and the courts have long recognized that companies financing the acquisition of equipment through a loan are the recipients of various tax incentives. These same bodies also have long recognized that equipment acquired through leasing involves the transfer of tax benefits from the user of the equipment to the owner-lessor. As a direct result of these sound tax policies, American citizens are the beneficiaries of the most modern and productive economy in the world. While equipment lessors would undoubtedly be negatively impacted by the proposed changes discussed above, the ultimate impact will be to drive up the cost of capital equipment acquisitions for U.S. businesses, particularly small businesses.

Statement of Financial Executives Institute ("FEI")

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

FEI's Committee on Taxation is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. FEI is a professional association comprising 14,000 senior financial executives from over 8,000 major companies throughout the United States. The Tax Committee, which formulates tax policy for the Institute, is comprised of the senior tax officers from over 30 of the nation's largest corporations.

FEI thanks the House Ways & Means Committee for scheduling these hearings on the Administration's budget proposals. We support a few of the proposals, for example, the extension of the tax credit for research. This provision should help improve the competitive position of U.S. companies. However, in many of the other tax proposals, the Administration replaced sound tax policy with some unwise revenue raisers. These latter proposals do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to extend Superfund taxes with no concomitant improvement of the cleanup programs, arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, and restrict the ability of "dual capacity taxpayers" to take credit for certain taxes paid to foreign countries.

Targeting publicly held U.S. multinationals doing business overseas for budget revenue raisers is unwise and FEI urges that such proposals not be adopted by Congress. Businesses establish foreign operations to serve local overseas markets so they are able to compete more efficiently with foreign based competition. In addition to assisting with the growth of exports and consequently job creation in the U.S., investments abroad help the U.S. balance of payments. The long-standing creditability of foreign income taxes is intended to alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will result in double taxation and greatly increase the costs of doing business overseas, which will place U.S. multinationals at a competitive disadvantage versus foreign based companies.

U.S. jobs and the economy overall would be best served by Congress working with the Administration to do all it can to make the U.S. tax code more friendly; a position already afforded our international competitors by their home country governments. The budget should be written with the goal of reintegrating sound tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and needless elimination of them will only distort that system. Higher business taxes impact all Americans, directly or indirectly. It should be kept in mind that millions of ordinary Americans are shareholders, through their retirement plans, of corporate America and that proposals that decrease the competitiveness of U.S. business harm those persons both as shareholders and employees.

EFFECTIVE DATES

FEI would like to voice its view that it is bad tax policy to add significant tax burdens on business in a retroactive manner. Businesses should be able to rely on the tax rules in place when making economic decisions, and expect that those rules will not change while their investments are still ongoing. It seems plainly unfair to encourage businesses to make economic decisions based on a certain set of rules, but then change those rules midstream after the taxpayer has made significant investments in reliance thereon. Thus, whenever possible, we call on Congress to assure that significant tax changes do not have retroactive application. To do otherwise can have a chilling effect on business investments that could be adversely impacted by rumored tax changes.

PROVISIONS THAT SHOULD NOT BE ADOPTED

Sound and justifiable tax policy should be paramount when deciding on taxation of business—not mere revenue needs. In this light, FEI offers the following comments on certain specific tax increase proposals set forth in the Administration's budget:

REPEAL OF CODE SECTION 863(B)

When products manufactured in the U.S. are sold abroad, Code Sec. 863(b) enables the U.S. manufacturer to treat half of the income derived from those sales as foreign source income, as long as title passes outside the U.S. Since title on export sales to unrelated parties often passes at the point of origin, this provision is more often applied to export sales to foreign affiliates.

The Administration proposes to repeal Sec. 863(b) because it allegedly gives multinational corporations a competitive advantage over U.S. exporters that conduct all of their business activities in the U.S. It also believes that replacing Sec. 863(b) with an allocation based on actual economic activity will raise $6.6 billion over five years. This proposal is nonsensical.

First, to compete effectively in overseas markets, most U.S. manufacturers find that they must have operations in those foreign markets to sell and service their products. Many find it necessary to manufacture products specially designed for a foreign market in the country of sale, importing vital components of that product from the U.S. wherever feasible. Thus, the supposed competitive advantage over a U.S. exporter with no foreign assets or employees is a myth. There are many situations in which a U.S. manufacturer with no foreign activities simply cannot compete effectively in foreign markets.

Second, except in the very short term, this proposal could reduce the Treasury's revenues rather than increase them. This is because the multinational corporations, against which this proposal is directed, may have a choice. Instead of exporting their products from the U.S., they may be able to manufacture them abroad to the extent of excess capacity in foreign plants. If even a small percentage of U.S. exporters are in a position to make such a switch, the proposal will fail to achieve the desired result and taxes on manufacturing profits and manufacturing wages will go to foreign treasuries, instead of to the U.S. Amazingly, the Administration seems to encourage this result by calling for an allocation based on "actual economic activity," which would cause a behavioral response to increase economic activity in foreign jurisdictions that could result in more foreign jobs, investment, and profits.

At present, the U.S. has too few tax incentives for exporters, especially compared to foreign countries with VAT regimes. The U.S. should be stimulating the expansion of exports. Given our continuing trade deficit, it would be unwise to remove a tax incentive for multinational corporations to continue making GATT legal export sales from the United States. Ironically, this proposal could result in multinationals using existing foreign manufacturing operations instead of U.S. based operations to produce export products. We encourage Congress not to adopt it.

FOREIGN BUILT-IN LOSSES

Another proposal would require the Treasury to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." The Administration argues that, although there are rules in the Code that limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain (e.g., Code Secs. 367(a), 864(c)(7), and 877), similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax and, as a result, taxpayers are avoiding Subpart F income inclusions or capital gains tax. We believe that this directive, which is written extremely broadly, is unnecessary due to the existence of rules already available in the Code, e.g., the anti-abuse provisions of Code Secs. 269, 382, 446(b), and 482. Both this proposal, and the one immediately above regarding the use of hybrid entities, would severely impact the ability of U.S. multinationals to compete on an equal footing against foreign-based companies.

FOREIGN OIL AND GAS INCOME

The President's budget proposal dealing with foreign oil and gas income moves in the direction of limiting use of the foreign tax credit on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. Perversely, this proposal cedes an advantage to overseas competitors by subjecting foreign oil and gas income to U.S. double taxation, which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

SUPERFUND TAXES

The three taxes that fund Superfund (corporate environmental tax, petroleum excise tax, and chemical feed stock tax) and the Oil Spill Fund Tax all expired on December 31, 1995. The President's budget would reinstate the two excise taxes at their previous levels for the period, as well as reinstate the Oil Spill Tax, effective after the date of enactment through September 30, 2009. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1998 and before January 1, 2010. In addition, the funding cap for the Oil Spill Tax would be increased from the current $1 Billion amount, to a much higher level of $5 Billion.

These taxes, which were previously dedicated to Superfund and the Oil Spill Fund, would instead be used to generate revenue to balance the budget. This use of taxes historically dedicated to funding specific programs for deficit reduction purposes should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

ELIMINATING THE DEDUCTIBILITY OF PUNITIVE DAMAGES

Another provision that clearly lacks any policy foundation (and appears to be included purely for revenue-raising purposes) is the proposal to deny all future payments associated with "punitive" damages incurred in civil law suits, effective for damages paid or incurred after the date of enactment. Civil punitive damages are a risk that virtually all companies are susceptible to in our present litigious society. They are often based on arbitrary and capricious jury awards and should be distinguished from the primarily criminal-type punitive damages currently denied deductibility under the Code. Punitive damages generally are subject to tax in the hands of the recipient under the changes made to those rules in 1996. In effect, Treasury seeks a windfall from punitive damage payments by denying their deduction while taxing their receipt. We adamantly oppose what would be a material change in the tax law.

INCREASING EXCISE TAXES ON TOBACCO

The Administration proposes new tobacco legislation that would provide for net revenues of approximately $34.5 billion over the five-year period from October 1, 1999, to September 30, 2004. We oppose any excise tax increases on tobacco because these higher taxes would clearly fall on those least able to pay (predominantly lower-income individuals). With a $700 billion surplus projected for the next 5 years, Congress should not even consider taxing individuals. This provision is merely another blatant revenue raiser.

TAXING ISSUANCE OF TRACKING STOCK

"Tracking stock" is an economic interest that is intended to relate to, and track the economic performance of, one or more separate assets of the issuer. It gives its holder a right to share in the earnings or value of less than all of the corporate issuer's earnings or assets. Under the proposal, upon issuance of tracking stock, gain would be recognized in an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis. Treasury views the issuance of tracking stock as tantamount to a spin-off and accordingly wants to impose tax. In fact, issuance of tracking stock is not a spin-off. The stockholder's value is still subject to the claims of the creditors of the parent corporation, and has liquidation or redemption rights only in the parent company, not the tracked assets. FEI opposes this attempt by Treasury to trigger a double tax on corporate income.

MODIFYING TAX TREATMENT OF DOWNSTREAM MERGERS

Under this provision, where a target corporation does not satisfy the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to the acquiring corporation, and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor, the target corporation must recognize gain, but not loss, as if it distributed the acquiring corporation stock that it held immediately prior to the reorganization to its shareholders. FEI opposes elimination of this longstanding and well-recognized ability to reorganize in a tax-free manner.

PREVENT TRAFFICKING IN BUILT-IN LOSSES

Under current law, a person that becomes subject to U.S. tax for the first time determines the basis of property and other tax attributes as though the person had always been subject to U.S. tax. This has been the rule since the beginning of the income tax. As a result, a taxpayer coming under the U.S. system may take advantage of built-in losses and would be taxed on built-in gains. Treasury wants to replace the current rule with a "fresh start" that eliminates all tax attributes (including built-in losses and other items) and marks the taxpayer's assets to market when they become subject to U.S. tax. The proposal could benefit some taxpayers who would be entitled to a tax-free step-up in basis in their appreciated property at the time they become subject to U.S. tax. This far-reaching proposal would add much complexity to the tax laws.

The Administration argues that although current rules limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain, similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax. Treasury's proposal, which is extremely broad, is unnecessary. Existing anti-abuse provisions such as sections 269, 382, 446(b), and 482 address this issue. Congress should resist the temptation that Treasury has placed before it to make an ad hoc, yet very fundamental, change to our international tax rules.

PAYMENTS TO 80/20 COMPANIES

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax provided the payor corporation is a so-called "80/20 Company," i.e., at least eighty percent of its gross income for the preceding three years is foreign source income attributable to the active conduct of a foreign trade or business. The Administration believes that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past and we do not believe such a drastic change is needed at this time.

MODIFYING THE SUBSTANTIAL UNDERSTATEMENT PENALTY

The Administration proposed to make any tax deficiency greater than $10 million "substantial" for purpose of the penalty, rather than applying the existing test that such tax deficiency must exceed 10% of the taxpayer's liability for the year. While to the individual taxpayer or even a privately-held company, $10 million may be a substantial amount of money—to a publicly-held multinational company, in fact, it may not be "substantial." Furthermore, a 90% accurate return, given the agreed-upon complexities and ambiguities contained in our existing Internal Revenue Code, should be deemed substantial compliance, with only additional taxes and interest due and owing. There is no policy justification to apply a penalty to publicly-held multinational companies which are required to deal with much greater complexities than are all other taxpayers.

The difficulty in this area is illustrated by the fact that the Secretary of the Treasury has yet to comply with Code Sec. 6662(d)(2)(D), which requires the Secretary to publish a list of positions being taken for which the Secretary believes there is not substantial authority and which would affect a significant number of taxpayers. The list is to be revised not less frequently than annually. Taxpayers still await the Secretary's *first* list.

INCREASED PENALTIES FOR FAILURE TO FILE RETURNS

The Administration also proposed to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

REPEALING LOWER OF COST OR MARKET INVENTORY METHOD

Certain taxpayers can currently determine their inventory values by applying the lower of cost or market method, or by writing down the cost of goods that are not salable at normal prices, or not usable because of damage or other causes. The Administration is proposing to repeal these options and force taxpayers to recognize income from changing their method of accounting, on the specious grounds that writing down unusable or non-salable goods somehow "understates taxable income." We strongly disagree with this unwarranted proposal. In addition, we believe that in the least, the lower of cost or market method should continue to be permissible when used for financial accounting purposes, to avoid the complexity of maintaining separate inventory accounting systems.

DEFERRAL OF OID ON CONVERTIBLE DEBT

The Administration has included a number of past proposals aimed at financial instruments and the capital markets, which were fully rejected during the last session of Congress. These reintroduced proposals should again be rejected out of hand. One proposal would defer deductions by corporate issuers for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g., no deduction would be allowed if the investors convert their bonds into stock). Investors in such instruments would still be required to pay income tax currently on the accrued interest. In effect, the proposal defers or denies an interest deduction to the issuer, while requiring the holder to pay tax on the interest currently.

FEI opposes this proposal because it is contrary to sound tax policy and symmetry that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. There is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that over 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Re-characterizing these instruments as equity for some purposes is fundamentally incorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital used to stimulate the economy. Introducing this imbalance and complexity into the tax code will discourage the use of such instruments, limit capital raising options, and increase borrowing costs for corporations.

ATTACKING LEGITIMATE CORPORATE TAX PLANNING

The Treasury Department's sweeping attack on corporate tax planning is alarming and unwarranted. The Administration's decision to seek a harsh new penalty regime and to impose Treasury and Internal Revenue Service judgements on taxpayers is disturbing. Merely labeling everything that it does not like as "corporate tax shelters" does not justify Treasury's attempt to tilt the tax playing field steeply and permanently in its favor. Well over 90 percent of President Clinton's tax increase proposals come from items previously rejected by Congress or from items that are substantive changes to long-standing and non-controversial provisions of the tax code.

The Administration's proposals to address what it labels as "tax avoidance transactions" are overly broad and would bring within their net many corporate transactions that are clearly permitted under existing law. Legitimate tax planning to conform to domestic and foreign non-tax legal or regulatory requirements may well be subject now to confiscatory penalties for failure to satisfy these overly broad standards.

The Administration wants to impose strict liability for a confiscatory 40-percent penalty on taxpayers who enter into transactions that IRS agents determine are uneconomic. The fact that the taxpayer acted reasonably and in good faith or had a substantial business purpose for the transaction would not matter. This is simply not the right standard. Our business transactions and the tax laws that apply to them are too complex. Taxpayers and the government inevitably will disagree. Taxpayers should be allowed to assert their views as freely as IRS agents assert theirs.

Since 1982, Congress has littered the Internal Revenue Code with penalties, disclosures, confiscatory rates of interest, and endless amounts of reporting. More than 75 sections of tax laws enacted since 1982 directly address corporate compliance from a penalty or procedural perspective. Today, if a corporate taxpayer enters into a transaction it believes is less-likely-than-not to result in the claimed tax benefits, that taxpayer faces substantial exposure on examination. The resulting deficiency could carry a 20 percent understatement penalty. Both the deficiency and the penalty would accrue interest at penalty rates. An advisor selling the transaction would be subject to registration, possible promoter and aiding and abetting penalties, and discovery by other clients.

TAX AVOIDANCE TRANSACTIONS

Treasury proposes five new rules built from a new concept: the "tax avoidance transaction." A tax avoidance transaction is defined as one in which the reasonably expected pre-tax profit of the transaction (on a present value basis) is insignificant relative to the reasonably expected net tax benefits of the transaction (on a present value basis). A transaction also is deemed to be a tax avoidance transaction if it involves "improper elimination or reduction of tax on economic income." In turn, a "corporate tax shelter" is defined as any entity, plan, or arrangement in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

This seemingly bright-line definition of a tax avoidance transaction is simply an invitation to an entirely new realm of ambiguity. Disputes would emerge over the general rules for measurement of profits; the treatment of non-deductible expenses and tax-free income; the reasonableness of expectations, discount rates, forecasting parameters; the allocation of general and administrative costs; the choice of applicable tax rates; assumptions about the state of the tax law; and dozens of other issues. As every member of the tax-writing committees knows from dealing with revenue estimates, it is much easier to know that an idea makes sense than to estimate its economic consequences with precision.

One bad answer to all of these questions is the probable Treasury response: "We will tell you in regulations." No regulation adequately could resolve the issues raised by these new concepts. Taxpayers would be left with the choice of doing things the IRS way or risking a no-fault penalty.

To function efficiently and productively, business taxpayers must be able to depend on the rule of law. That means relying on the tax code and existing income tax regulations. If the Administration's vague "tax shelter" proposals become law, few businesses would feel comfortable relying on those statutes or regulations. Treasury's proposed rules could cost the economy more in lost business activity than they produce in taxing previously "sheltered" income.

RESTRICTING CORPORATE TAX PLANNING

The provision imposing a 20-percent strict liability penalty on any underpayment associated with a tax avoidance transaction is wrong. Taxpayers should have the freedom to take reasoned, reasonable, and supportable positions on their tax returns. Increasing the penalty to 40 percent if the taxpayer failed to report its participation in the transaction within 30 days of entering into it is simply setting a trap for ordinary businesses. Tax lawyers and accountants are not at every business meeting ready to file reports to the IRS.

Treasury's request for blanket regulatory authority to extend section 269 to disallow any deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction is nothing more or less than a request that the Congress turn over a substantial portion of its tax-writing responsibilities to un-elected executive branch officials.

Treasury also wants Congress to deny corporate taxpayers any deduction for fees paid in connection with the purchase or implementation of a tax avoidance transaction or for related tax advice. Advisors also would be subject to a 25 percent excise tax on such fees. Corporate tax directors and their outside advisors are not criminals. By denying a deduction and imposing an excise tax, this proposal would provide harsher treatment under the tax code for legitimate tax-planning activity than that applicable to illegal bribes, kickbacks, penalties for violations of the law, and expenditures in connection with the illegal sale of drugs.

Purchasers of a corporate tax shelter who also acquire a full or partial guarantee of the projected benefits would be subject to an excise tax equal to 25 percent of the benefits that were guaranteed. Congress ought to stay out of the private marketplace. In truth, insurance of a tax result is merely the expression of someone's opinion that the transaction will work. The Administration would say that if a taxpayer purchases insurance against a tax adjustment in a specific transaction for $10,000 and the limit on the policy is $1,000,000, the proposal would subject the corporate client to a $250,000 tax. The insurer obviously has a lot of faith in the transaction to be willing to take a risk premium equal to 1 percent of the exposure.

The proposals would also tax otherwise tax-exempt entities when they are parties to a corporate taxpayer's tax avoidance transaction. The law is already filled with rules to prevent arbitrage with exempt entities. Taxing hospitals, universities, and pension funds because some IRS agent found a tax shelter on the other side of one of their transactions is not a solution to any problems that may still exist. The proposal targets exempt organizations, Native American tribal organizations, foreign persons, and domestic corporations with expiring net operating losses. The corporate parties would be jointly and severally liable for this tax if unpaid by the exempt taxpayer. In addition, in the case of a foreign person properly claiming the benefit of a treaty, or a Native American tribal organization, the tax on the income allocable to such persons in all cases would be collected from the corporate parties.

An additional provision would preclude taxpayers from taking tax positions inconsistent with the form of their transactions if a tax-indifferent party was involved in the transaction. A taxpayer could take an inconsistent position by disclosing the inconsistency. In effect, the rule is a reporting requirement (chiefly with respect to hybrid transactions) masquerading as a deduction limitation.

In summary, the Clinton Administration's attempt to tilt the playing field in favor of the IRS would make it very difficult for taxpayers to engage in legitimate transactions to (1) reduce U.S. tax with foreign losses, (2) reposition companies for better loss utilization, (3) undertake tax reducing stock sales across internal corporate ownership chains, (4) use hybrid financing techniques, (5) sell assets at reduced tax rates, and/or (6) create mergers that streamline corporate structures. These actions would hurt the ability of U.S. corporations to operate economically and to compete effectively against their foreign-based competitors. Congress must reject this power grab by the IRS and Treasury.

PROVIDING CONSISTENT AMORTIZATION OF INTANGIBLES

Under current law, start-up and organizational expenditures are amortized at the election of the taxpayer over a period of not less than 60 months. Certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business or an activity for the production of income must be amortized over 15 years. Under the budget proposals, start-up and organizational expenditures would be amortized over a 15-year period. Small businesses would be allowed a $5,000 expensing of such costs. FEI believes that the proper treatment of many start-up and organizational expenses in a neutral tax system would be expensing. Moving in the opposite direction, toward a longer artificial recovery period for such expenses, is simply increasing taxes on companies that are growing and expanding.

MODIFYING RULES FOR DEBT-FINANCED PORTFOLIO STOCK

This proposal would effectively reduce the dividends-received deduction ("DRD") for any corporation carrying debt—virtually all corporations—and would specifically target financial service companies, which tend to be more debt-financed. FEI vigorously opposes this proposal, as it has opposed more straightforward proposals to reduce the DRD in the past.

The purpose of the DRD is to eliminate, or at least alleviate, the impact of potential multiple layers of corporate taxation. Under current law, the DRD is not permitted to the extent that relevant "portfolio stock" is debt financed. Portfolio stock is defined as stock in which the corporate taxpaying owner holds less than 50 percent of the vote or value. Portfolio stock has generally been treated as debt financed when acquired with the proceeds of indebtedness, or when it secures the repayment of indebtedness. The Administration's proposal would expand the DRD disallowance rule of current law for debt financed stock by assuming that all corporation debt is allocated to the company's assets on a pro-rata basis. The proposal would, thus, partially disallow the DRD for all corporations based on a pro-rata allocation of its corporate debt.

We believe the proposal would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more fair, rational, and simple tax system. Just as troubling is the notion that the DRD should be dramatically reduced for companies, including financial service companies, that are highly leveraged. The proposal is particularly problematic for the securities industry, which maintains large quantities of equity investments in the ordinary course of its business operations. FEI believes that multiple taxation of corporate earnings should be reduced, rather than expanded. The Administration's proposal clearly moves in the wrong direction.

ELIMINATING THE "DRD" FOR CERTAIN PREFERRED STOCK

Another proposal would deny the dividend received deduction ("DRD") for certain types of preferred stock, which the Administration believes are more like debt than equity. Although concerned that dividend payments from such preferred stock more closely resembles interest payments than dividends, the proposal does not simultaneously propose to allow issuers of such securities to take interest expense deductions on such payments. Again, the Administration violates sound tax policy and, in this proposal, would deny these instruments the tax benefits of both equity and debt.

FEI opposes this proposal as not being in the best interests of either tax or public policy. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received by corporations that own over 80 percent of other corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the U.S. To further decrease the DRD would be another move in the wrong direction.

DEFERRED ACQUISITION COST CAPITALIZATION PERCENTAGES

This proposal would increase the percentage of life insurance and annuity premiums subject to DAC capitalization. House Ways and Means Committee Chairman Bill Archer, R-Texas, already has publicly announced that the DAC proposal will not be included in any package put forth by his committee. We are in full agreement with him. The current DAC rates are more than appropriate in light of the other rules that apply to life insurance companies that tend to overstate their income for tax purposes.

MODIFYING CORPORATE-OWNED LIFE INSURANCE RULES

Treasury continues its four-year assault on COLI programs by proposing to repeal an exception to the present law proportionate interest disallowance rules for contracts on employees, officers or directors, other than 20 percent owners of the business that are the owners or beneficiaries of an annuity, endowment, or life insurance contract. This exception was designed to allow employers to create key-person life insurance programs, fund non-qualified deferred compensation with the advantages of life insurance, and meet other real business needs. The effect of this proposal would be to tax the inside build up in cash value life insurance whenever it is owned by a business that also has debt. Given the very long-term nature of life insurance investments, this rule would make insurance unattractive even to companies with no debt today, because they might need to borrow at some future date.

RECAPTURING POLICYHOLDER SURPLUS ACCOUNTS (PSA)

Life insurance companies that were taxed under the old "phase II positive" regime of the 1959 Act would have their tax bills for 1959 through 1983 rewritten by Treasury's proposal to tax policyholder surplus accounts. Companies would be required to include in their gross income over 10 years (one-tenth per year) the balances of the policyholder surplus accounts accumulated from 1959 through 1983. These accounts were part of a complex, Rube Goldberg set of provisions designed to balance the tax burdens of various segments of the insurance industry. Different companies benefited from different provisions, retroactively denying one set of companies their treatment is fundamentally unfair. Companies with policyholder surplus accounts never expected to pay tax on them. Congress should not change the rules at this late date.

CONVERTING THE AIRPORT AND AIRWAY TRUST FUND

The Administration wants to restructure the Airport and Airway Trust Fund. FEI has no opinion on those proposals. The Administration also wants to lower air ticket taxes and in their place impose FAA user fees. This all ends up with an extra $5.3 billion going to Washington. FEI opposes increasing government revenues from the air transportation sector. The Airport and Airway Trust Fund is not spending what it has. Why is more needed? The assets in the trust fund are projected to grow from $12.3 billion in 1999 to $20.9 billion in 2004. It is hard to understand why we need a $5 billion cost increase to the public, much of which would be paid by the business community.

ELIMINATING NON-BUSINESS VALUATION DISCOUNTS

The proposal would deny any valuation discounts for interests in entities holding "non-business assets." This provision would eliminate most of the value of using family limited partnerships to reduce the transfer tax value of gifted or inherited property. Although FEI takes no position on estate and gift tax issues, we do note that this proposal is an unmistakable tax increase.

TAXING INVESTMENT INCOME OF TRADE ASSOCIATIONS

Under the proposal, trade associations (including FEI) of commerce, business leagues, and other similar not-for-profit organizations organized under Internal Revenue Code section 501(c)(6) generally would be subject to tax on their net investment income in excess of $10,000. FEI opposes this $1.4 billion tax increase on trade associations. The current-law purpose of imposing unrelated business income tax on associations and other tax-exempt organizations is to prevent such organizations from competing unfairly against for-profit businesses. Subjecting trade association investment income to UBIT is counter to this legislative purpose. The Treasury proposal mischaracterizes the benefit that trade association members receive from such earnings. If these earnings on a trade association's assets did not exist, members of these associations would have to pay larger tax-deductible dues. There simply is not a tax abuse here. Congress should leave the present law rules as they are.

POSITIVE TAX PROPOSALS

As stated above, certain of the Administration's tax proposals will have a positive impact on the economy. For example:

EXTENSION OF RESEARCH TAX CREDIT

The proposal to extend the research tax credit is to be applauded. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets—especially in what some refer to as the Information Age. Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. FEI recommends that Congress work together with the Administration to extend the research tax credit on a permanent basis.

ACCELERATING EFFECTIVE DATE OF 10/50 COMPANY CHANGE

Another proposal would accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-called "10/50 Companies"). This change will allow 10/50 Companies to be treated just like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits ("E&P") generated before the year 2003, and dividends from E&P accumulated after the year 2002. The Administration's proposal will, instead, apply the look-through rules to all dividends received in tax years after 1998, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws, and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S. based multinationals.

MAKING PERMANENT THE EXPENSING OF REMEDIATION COSTS

The Administration's proposal to make permanent the current deductibility of costs for so-called "brownfields" remediation under Code section 198 is a welcome extension of a change contained in the 1997 Taxpayer Act, which allowed certain remediation costs incurred with qualified contaminated sites (so-called "brownfields") to be currently deductible as long as they are incurred by December 31, 2000. Extension of this treatment on a permanent basis removes any doubts among taxpayers as to the future deductibility of these expenditures and promotes the goal of encouraging environmental remediation.

EXTENDING NOL CARRYBACK PERIOD FOR STEEL COMPANIES

The Administration's proposal to extend the carryback period for net operating losses ("NOLs") of steel companies from two to five years is both fair and equitable due to the financial troubles that many steel companies are experiencing. The benefit provided by this longer carryback period would feed directly into a financially troubled steel company's cash flow, providing immediate and necessary relief. Our only suggestion is that this longer carryback period be extended to other troubled industries, such as the petroleum, chemical, and aerospace industries, to name a few.

CONCLUSION

FEI urges Congress not to adopt the revenue raising provisions identified above when formulating its own budget proposals. They are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

The Administration's proposals would add complexity in direct contrast to the Administration's stated need to simplify the tax law in order to assist the Internal Revenue Service in more effectively filling its role as the nation's tax collector. We thank the Committee for this opportunity to share our views on this important subject.

Statement of General Motors Corporation

The Clinton Administration proposes to tax the issuance of tracking stock, a type of stock that tracks the economic performance of less than all the assets of the issuing corporation. General Motors Corporation ("GM") has a unique perspective on this proposed legislation. GM was the first publicly-traded company to issue tracking stock (GM's Class E Common Stock), in connection with its acquisition of Electronic Data Systems Corporation ("EDS") in 1984. In total, GM has issued more than $10 billion in tracking stocks and has nearly $5 billion in such stock outstanding currently.

GM believes that it would be beneficial for the Committee to understand (1) the business circumstances that caused GM to create tracking stock in the first instance and (2) GM's experience with this stock since it was first issued. GM's experience demonstrates that tracking stock is an exceedingly valuable business mechanism that cannot reasonably be used for tax avoidance. GM strongly urges this Committee to reject the Administration's proposal to tax the issuance of tracking stock.

GM'S EXPERIENCE WITH TRACKING STOCK

GM is the world's largest manufacturer and distributor of motor vehicles. In 1998, GM had worldwide sales of more than $160 billion and provided employment to more than 600,000 workers.

A. Acquisitions of EDS and Hughes Aircraft Company

In the mid–1980's, GM was concerned that the company needed to be better prepared for the cyclical downturns in the U.S. automotive market. The company was primarily a manufacturer of automobiles and automotive components, which made GM vulnerable to the periodic recessions that occur in the automotive industry. At the same time, GM was attempting to implement cost-effective data processing systems across its worldwide operations. GM also believed that it had to increase its high technology expertise as a means to accelerate the application of electronics in its automotive products.

GM thought the best way to diversify its earnings base to withstand economic downturns, reduce its cost structure, and address the need for increased electronic content in its automotive products was to make significant acquisitions in the computer servicing, data processing, and high-technology electronics industries. Toward that end, GM began to investigate the acquisition of two companies, EDS and Hughes Aircraft Company ("Hughes"). EDS was then a rapidly growing data processing and computer company located in Dallas, Texas. GM believed that the integration of GM's automotive business with EDS's computer expertise would provide GM an "electronic backbone," increase GM's marketing efficiencies and reduce its cost structure. Hughes was one of the leading defense electronics companies in the world, with expertise in engineering, electronics and science. GM believed a combination of its automotive manufacturing business with Hughes' engineering and electronics expertise would dramatically improve GM's products. Moreover, the ownership of EDS and Hughes would make GM a more diversified company and thus reduce the cyclicality of GM's earnings.

GM negotiated the acquisition of EDS with EDS's top executives, principally Ross Perot and Morton Meyerson. EDS's executives were intrigued by the growth potential that could result from a merger with GM, but they had many concerns about receiving ordinary GM common stock as the merger consideration. EDS perceived itself as a nimble, high-growth, high-technology company, and the company's executives worried about the consequences of merging into GM and staking their economic fortunes with those of a slower-growth, mature automotive company. In particular, EDS's executives were concerned that GM's enormous size would render EDS's successes immaterial to GM and would suppress EDS's entrepreneurial spirit. EDS was also concerned that its employees would not be motivated by holding stock and stock options in a company whose stock price they could not meaningfully influence by their efforts.

GM tracking stock was the key to persuading EDS to merge with GM. GM's Class E Common Stock had liquidation and bankruptcy rights on an equal footing with GM's existing common stock and represented a full integration of GM's assets with EDS's assets. Class E Common Stock voted in the election of GM's Board of Directors, and had no voting rights in the election of EDS directors. However, the dividends on the Class E Common Stock would be payable by GM based on the earnings of EDS. GM anticipated that the Class E Common Stock's value would reflect primarily the performance of EDS. The idea for this stock was not driven or motivated by tax considerations (the acquisition was fully taxable to EDS's shareholders), but instead was created by business people seeking to solve a business problem.

The creation of this stock in fact solved the problems identified by EDS's executives and permitted the merger to go forward. The creation of Class E Common Stock created a separately-traded equity that could be separately valued, and in turn this equity could be made available to EDS employees to provide direct incentives for them to improve and grow their distinct business. As a service business, it was critical to EDS's stability and growth that it retain its key employees. At the same time, GM was able to acquire all of EDS and integrate EDS's expertise into GM's automotive business.

Shortly after GM completed its acquisition of EDS, GM began negotiations with the Howard Hughes Medical Institute ("HHMI") for the acquisition of Hughes. Hughes was a premier high-technology company. Whereas EDS's expertise was in computer software and data processing, Hughes' line of business was high-technology electronics and engineering. But the HHMI expressed concerns similar to those heard from EDS executives about receiving GM automotive stock as the merger consideration. HHMI perceived GM's automotive stock as a relatively unattractive investment. By offering HHMI a GM tracking stock whose dividends were based on the earnings of Hughes' business, the merger proposal became more attractive to HHMI. GM was thus able to complete this acquisition in 1985.

The acquisitions of Hughes and EDS undeniably played an important role in the resurgence of GM. EDS and Hughes brought new engineering and scientific expertise, managerial focus, high technology, capital and growth to GM. At the same time, being owned by GM benefitted both EDS and Hughes. The values of Class E Common Stock and Class H Common Stock both experienced significant growth. And with the increased capital that GM was able to provide Hughes, Hughes (i) made technological advances that have markedly improved the technological content of GM vehicles (such as "head-up" displays), and (ii) created new nonautomotive products that have benefitted the U.S. economy, including well-known consumer goods such as DirecTV and pay-at-the-pump fuel stations.

B. Funding GM's Defined Benefit Pension Plan

While the acquisitions of Hughes and EDS helped reenergize GM, the economic downturn in the early 1990's adversely affected GM's financial position. At that time, GM's defined benefit pension plan for its U.S. automotive workers became severely underfunded, and the company did not have the cash to eliminate that underfunding. The underfunding of the GM plan was estimated to represent approximately 50% of the entire contingent underfunding liability of the Pension Benefit Guaranty Corporation ("PBGC"), which generated substantial controversy and concern at that government agency and in the media.

In order to fund its pension plans, GM began working with the PBGC and the Departments of Labor and Treasury to make a substantial contribution of Class E Common Stock to the GM pension plans. In general, the PBGC does not favor a corporation's pension plan being funded with traditional employer company stock, since any downturns in that company's business will reduce the company's ability to make future contributions and at the same time cause the company's underfunding to increase as its stock price declines. In this case, however, the PBGC reacted positively to GM's suggestion of a contribution of Class E Common Stock since the fortunes of this stock were less tied to GM's automotive business. Working with the PBGC and the Departments of Labor and Treasury, GM successfully completed in March 1995 a contribution of approximately $7 billion of Class E Common Stock to the GM plans. This contribution dramatically reduced the level of GM's underfunding (and in turn the PBGC's contingent liability), in a way that would not have been possible without the use of tracking stock.

GM's use of tracking stock to fund its pension plan did not constitute any form of tax avoidance and was not motivated by tax reasons. Indeed, GM made this contribution only after extensive collaboration with the Treasury Department, the Labor Department, and the PBGC. Each government agency supported GM's issuing Class E Common Stock to fund GM's pension plan.

C. Recent Experiences with Tracking Stock

GM ultimately spun off EDS to GM's shareholders in 1996, nearly 12 years after GM had acquired EDS. The spin-off was accomplished tax-free under Code § 355, with GM receiving a ruling from the IRS that the spin-off met all relevant requirements of the Internal Revenue Code. GM spun off EDS because GM concluded that it could continue to enjoy the benefits of EDS's expertise through a long-term supply agreement. At the same time, EDS's business had progressed to the point where EDS concluded that being owned by GM was detrimental to its ability to attract new business from customers or enter into strategic alliances with third parties. A spin-off with a long-term supply agreement thus benefitted both parties.

As GM was considering the strategic alternatives available to it regarding EDS, one alternative that was briefly considered was to sell a substantial block of Class E Common Stock to a company interested in purchasing a controlling interest in EDS. While GM believes that it had strong business reasons for such a transaction, such a sale arguably might have been the type of transaction that the Clinton Administration finds objectionable about tracking stock, i.e., a sale of tracking stock in lieu of a sale of subsidiary stock. But when GM negotiated with potential strategic purchasers, none of them was willing to invest in EDS without acquiring a direct ownership in EDS's assets or having a significant voice in EDS management.

Each potential strategic purchaser noted that if GM were to go bankrupt or have trouble paying creditors, the assets of EDS would be available to satisfy the claims of GM creditors. Consequently, every potential strategic purchaser of a substantial portion of EDS rejected any suggestion that it simply acquire Class E Common Stock. This reluctance demonstrates why the Clinton Administration's concerns about tracking stock are hypothetical, not real. There is no practical way to dispose of a subsidiary through the sale of tracking stock. Potential strategic purchasers are unwilling, for substantial business reasons, to purchase tracking stock instead of the underlying subsidiary's stock or assets.

In 1997, GM also disposed of the defense electronics business of Hughes. This transaction was accomplished by spinning off the Hughes Defense business to all classes of GM shareholders, with Hughes Defense then merging with Raytheon Corporation. GM's Class H Common Stock remained outstanding, with such stock continuing to track the earnings of Hughes' remaining businesses (principally telecommunications and satellites). This transaction was tax-free under Code § 355, with GM receiving a favorable ruling from the IRS. The existence of Class H Common Stock in no way facilitated this transaction. Indeed, the existence of GM tracking stock was, if anything, a complicating factor, since it required GM, among other things, to weigh the relative interests of its different classes of common stock, determine that the spin off and related transactions were fair to all classes of GM stockholders, and condition the transactions on approvals by each class of GM common stock.

Lessons Learned from the GM Experience

GM's experience with tracking stock demonstrates conclusively why tracking stock is a valuable business tool and not a tool for tax avoidance. The lessons from the GM experience include the following:

A. Compelling Business Purposes

The stated concern of the Clinton Administration is that corporations will issue tracking stock in order to dispose of a business without paying the tax that would normally be owed after a taxable sale. We are aware of no case where this has ever occurred. Corporations generally issue tracking stock when they *acquire* (not sell) a new business or when they need to raise additional capital to expand or preserve a business. For example:

- GM issued tracking stock when it acquired EDS and Hughes
- Genzyme issued tracking stock in order to obtain funding for its research and development activities
- Sprint issued tracking stock when it acquired all of the stock of Sprint PCS
- USX issued tracking stock when it needed additional capital to restore its steel business
- GM issued tracking stock in order to alleviate the underfunding in its pension plan

GM could not have acquired EDS or Hughes without the ability to issue tracking stock, since the prior owners of EDS and Hughes did not view GM's automotive stock as an attractive investment. Nor could it have funded its underfunded pension plan without tracking stock, since a large block of GM automotive stock was not an appropriate mechanism to fund the GM pension plans.

B. Investor Choice

Tracking stock permits greater investor choice. Investors can choose the business operations of a corporation in which they wish to invest, as opposed to investing in a corporate conglomerate. In today's specialized financial markets, many mutual funds and other investors invest only in certain types of companies, such as sector funds that only invest in computer or technology companies. Most sector funds do not invest in the stock of corporate conglomerates. By issuing tracking stock, GM created separately traded stocks that were purchased by investors who otherwise would not have been willing to invest in the GM group as a whole.

This element of investor choice continues to reflect itself in GM's shareholder base even today. GM's automotive stock is an attractive investment for so-called value investors, i.e., investors who prefer equities with a lower price-to-earnings ratio that pay a reasonable dividend. GM's Class H Common Stock, on the other hand, is a growth stock with a high price-to-earnings ratio that does not currently pay dividends. If GM had only one class of equity outstanding, the GM story would be confusing to the marketplace, and, for example, investors in growth stocks would not be attracted to invest in the GM group.

C. Raising Capital

Tracking stock provides an efficient mechanism to raise capital. Many of the corporations that have issued tracking stock are mature businesses whose stocks trade at relatively low price-to-earnings ratios, such as GM (autos), USX (steel), Pittston (coal), and Georgia Pacific (forestry), but who own subsidiaries that are in different businesses. If these corporations were to issue their own stock in a tax-free public offering, the proceeds received in exchange for the equity surrendered would reflect the low price-to-earnings ratio of the core business. By issuing tracking stock that tracks the business of a higher-growth subsidiary, the issuing corporation is able to raise more capital with less dilution to existing shareholders. And by doing so, the issuing company's ability to invest and grow its own business is enhanced.

This value disparity can clearly be seen in GM's experience with tracking stock. GM's automotive stock has typically traded at a price-to-earnings multiple of approximately 8–10. GM's Class E Common Stock typically traded, however, at a multiple of from 20–30; GM's Class H Common Stock also trades at very high multiples, currently above 60. When GM needed to fund its pension plan in the early 1990's, GM was able to provide approximately $7 billion to the plan by issuing high-multiple Class E Common Stock. If GM had been required to issue its automotive stock to the plan, a much greater amount of shareholder dilution would have been required in order to provide $7 billion of funding.

D. Executive Accountability and Employee Incentives

Corporate officers invariably are more focused on shareholder value when they know that their actions will directly affect equity valuations. In the absence of tracking stock, executives at Hughes and EDS would have known that their actions would have had only minimal influence on GM's stock price, since the equity markets invariably have valued GM's business principally on the performance of GM's automotive business.

By creating separate tracking stocks, employees at EDS and Hughes knew that their actions had a more direct impact on stock values. From a shareholder perspective, a tracking stock much more closely aligned the financial incentives of EDS and Hughes' employees with those of GM's shareholders. The existence of tracking stock also permitted employees to receive stock in their 401(k) plans and stock options whose value was tied to the business at which they worked. It was these types of issues that principally caused GM to propose tracking stock when it acquired EDS in 1984.

E. Shareholder Value

Tracking stock is a powerful generator of shareholder value. Equity markets tend to discount conglomerates, valuing an entire business at less than its component parts are worth. Tracking stock permits each distinct business to be separately valued on its own fundamentals and earnings, while at the same time allowing corporate groups to obtain operating synergies and economies of scale.

The value enhancement possible through tracking stock was clearly seen on March 10, 1999, when DuPont Corporation announced that it would issue a class of DuPont tracking stock to track DuPont's life sciences business. DuPont's stock rose nearly 8% in value upon this announcement. Moreover, DuPont's stated reasons for issuing this stock were the textbook case for tracking stock. DuPont's mature chemical business traded at a relatively low price-to-earnings ratio, masking the value of DuPont's high-value pharmaceuticals and life sciences business. By issuing tracking stock, DuPont intends to unlock the value of its life sciences business, while also creating an acquisition currency that it can use to make acquisitions in the life sciences business.

F. Tracking Stock Not Used for Tax Avoidance Purposes

The Clinton Administration proposes to tax tracking stock based on the assumption that such stock can be used for tax avoidance. However, tracking stock carries none of the indicia of tax avoidance. The hallmark of corporate tax avoidance transactions is that such transactions are effected without public disclosure, without any business purpose or economic substance, in order to generate artificial tax losses. In contrast, tracking stock issuances have all been fully disclosed to shareholders and have been completed only when the use of tracking stock made compelling business sense.

The Administration also is apparently concerned that a corporation will simply sell tracking stock in order to dispose of a subsidiary, in lieu of selling the subsidiary's stock in a taxable sale. This concern ignores what has actually happened in the marketplace with tracking stock. GM issued both Class E Common Stock and Class H Common Stock for business reasons to consummate important acquisitions for the company. GM believes that the other public corporations that have issued tracking stock have also done so for strong business reasons. Tracking stock is an effective business tool for making acquisitions and raising capital, but it cannot realistically be used for dispositions.

As discussed above, GM considered selling a substantial block of Class E Common Stock to potential strategic purchasers of EDS in the early 1990's. GM quickly learned that it was just not possible to effect such a transaction. No potential strategic purchaser was willing to purchase any significant amount of tracking stock, because tracking stock does not carry with it any rights to manage and control the underlying assets. Moreover, the strategic purchaser's economic investment would have remained linked to the economic fortunes of GM, a scenario that was unacceptable to any potential purchaser. Based on its experience with tracking stock, GM believes that tracking stock cannot realistically be used in the way that the Clinton Administration apparently fears, i.e., tracking stock offers no reasonable avenue for tax avoidance and cannot be used to effect an otherwise taxable sale.

Another impediment to using tracking stock for tax purposes is that such stock is complex and cannot be issued or sold without substantial public disclosure and explanation to shareholders. When corporations have sought to issue tracking stock without a compelling business reason, shareholders have rejected it (as, for example, K-Mart's shareholders did in 1994). In the fifteen years since tracking stock was first issued, we are aware of only fifteen public companies that have issued such stock.

G. Congress Has Already Enacted, and Treasury Can Adopt, Provisions to Ensure that Tracking Stock Cannot Be Used for Tax Avoidance

The concerns of the Clinton Administration appear to be based on a fear that a taxpayer might use tracking stock to sell off its interest in a subsidiary to a third party without paying tax on any gain realized from appreciation in that subsidiary. Fifteen years of history with tracking stock shows, however, that such stock has not been used for tax avoidance. The fears of the Administration thus are premised on hypothetical tax avoidance, as opposed to a response to any actual abuses involving tracking stock.

The Administration proposal also ignores two important facts: Congress has already enacted legislation to ensure that tracking stock is not used as a substitute for selling the subsidiary itself, and Treasury has the authority under Code § 337(d) to enact regulations if any taxpayer in fact creates some as-yet-unidentified way to use tracking stock for tax avoidance purposes.

In 1990, Congress enacted Code § 355(d)(6)(B)(iii). This statute prevents a parent corporation from selling a large block of tracking stock to a third party and then later distributing the stock of the tracked subsidiary to that third party in a tax-free split-off under Code § 355. This statute thus addresses the exact situation that the Clinton Administration is apparently concerned about—the sale of tracking stock to a third party as a substitute for a taxable divestiture. Code § 355(d) is premised on the assumption that no third party would ever agree to purchase a business via the use of tracking stock unless that third party knew that ultimately the tracking stock would be unwound and the third party would receive the underlying business via a tax-free spin-off. Code § 355(d)(6)(B)(iii) prevents this technique.

In addition, Code § 337(d) provides Treasury with the authority to issue regulations to carry out the purposes of so-called "*General Utilities* repeal," i.e., to ensure that corporations cannot sell the stock of a subsidiary at a gain without incurring a tax liability. If Treasury had any specific concerns that tracking stock was being used to avoid *General Utilities* repeal, this statute gives Treasury full authority to issue regulations to prevent that avoidance. Since Code § 337(d) was enacted in 1986, Treasury has not adopted any regulations to address any perceived tracking stock abuses, because, we believe, there have been no abuses. In the event Treasury becomes concerned that tracking stock is being used in some specified tax-avoidance manner, Treasury should use the authority already given it to implement a targeted response, instead of simply asking Congress to effectively eliminate the use of tracking stock altogether (as the Clinton Administration proposal would surely do).

CONCLUSION

GM recognizes that both the Clinton Administration and the Congress have a real and substantial interest in curtailing the use of tax avoidance mechanisms and tax shelters by corporations. GM believes that corporate use of inappropriate shelters merits this Committee's attention and remediation. However, we are aware of no circumstance where any corporation has used tracking stock as a tax avoidance mechanism.

Corporations that have issued tracking stock have done so for compelling business reasons. The proposed new rules for taxing tracking stock would have the effect of virtually eliminating a legitimate and valuable business mechanism, hurting shareholder value, restraining capital formation and job creation, and giving rise to marketplace and employee confusion, while doing nothing to eliminate tax avoidance.

GM strongly urges this Committee to reject the Administration's proposal to tax the issuance of tracking stock. Thank you.

Statement of Governors' Public Power Alliance, Lincoln, Nebraska

The Governors' Public Power Alliance is pleased to submit this statement to the Committee on Ways and Means, U.S. House of Representatives, on the revenue provisions in the Clinton administration's fiscal year 2000 budget. The Alliance is specifically concerned about the electricity restructuring provisions found in the FY 2000 budget: Deny tax-exempt status for new electric utility bonds except for distribution related expenses.

The Governors' Public Power Alliance, a bipartisan Alliance of governors, was formed so that federal initiatives do not disadvantage the millions of Americans who are served by locally and consumer-owned electric utilities.

Tennessee Governor Donald Sundquist and Nebraska Governor Mike Johanns chair the Alliance. Alaska Governor Tony Knowles is vice chairman. Other Alliance members are Florida Governor Jeb Bush, South Dakota Governor Bill Janklow, Puerto Rico Governor Pedro Rossello and Washington Governor Gary Locke.

THE ALLIANCE AND ELECTRIC UTILITY RESTRUCTURING

One of every four American consumers receives electric power from consumer-owned electric systems or member-owned rural electric cooperatives. These are locally owned assets that for more than 115 years have made enormous contributions to the nation's economic prosperity and that of our states, cities and rural areas. Their local ownership and not-for-profit mission makes them very different from private companies, requiring different solutions to the challenges of the new marketplace envisioned by restructuring advocates.

The federal government can't create one restructuring model and expect all 50 states to follow it. Every one of our states has unique characteristics that will make a " one-size fits all" federal model unworkable, unfair and costly to consumers.

The governors are concerned that consumers served by local and regional electric systems may be overlooked in federal legislative and regulatory proposals. The more than 2,000 publicly owned electric systems and 900 plus rural electric cooperative utilities may be seen as small when compared with the nation's 240 investor-owned electric companies, they provide essential services to a large portion of America's electric customers.

The Alliance subscribes to these principles dealing with electric utility restructuring:

- Several issues are solely within federal jurisdiction and must be addressed to open the door to retail competition and foster the development of competitive markets.
- The cornerstone of federal policy should be a commitment to respect state and local decision-making.
- It is inappropriate for the federal government to preempt state and local restructuring efforts. Instead, the federal government should respect the traditional prerogative of state and local authorities to regulate retail utility transactions and support their efforts.
- Any federal legislation should facilitate state and local decisions regarding retail competition.
- Federal barriers to competition should be eliminated.
- Federal legislation is needed to establish additional protections against the establishment and abuse of market power.

Public power's first and only purpose is to provide excellent, efficient service to their local citizens/customers at the lowest possible cost. Like hospitals, community schools, water, sewer, parks, police and fire departments, these "public power" systems are locally created institutions that address a basic community need: they operate to provide an essential public service at a reasonable, not-for-profit price. Public power systems are governed democratically through their state and local government structures. They operate in the sunshine, subject to open meeting laws, public records laws and conflict of interest rules. Most, especially the smaller ones, are governed by a city council, while oftentimes an elected or appointed board independently governs others.

Local power customers are direct stakeholders in the utilities' operations and future. In turn, public power utilities are community institutions with community-wide goals. As state and local government organizations and entities, they boost economic development, return taxes and make in-lieu-of-tax payments to states and communities, and lower citizen costs through coordination of services with other government entities. Local electric systems give citizens—as direct stakeholders—opportunities to participate in service, financial and operating decisions. For purposes of competition, they serve as an important yardstick against which to measure the price, service, reliability and performance of private power companies.

While restructuring of the electric industry and introducing competition will likely give consumers new choices in terms of their purchase of electric power, through their state and local governments, consumers have always had a choice between creating their own public power systems or awarding franchises to private power companies. We wish to preserve this choice for all citizens.

ELECTRIC UTILITY RESTRUCTURING AND TAX EXEMPT BONDS

Substantial portions of generation, transmission and distribution facilities owned by public power systems were financed through the issuance of tax-exempt bonds. These bonds, like bonds for all types of governmental purposes, carry with them restrictions on the amount of private use allowed for those facilities. While sound tax policies may warrant certain restrictions on private use of public facilities, public power facilities have been singled out for unduly restrictive treatment.

These private use restrictions, which previously had a negative but survivable impact on the financing of community owned and operated electric output facilities, in their new form—and in the new competitive environment—will restrict the financing of governmental facilities far beyond the intention of Congress expressed in the Tax Reform Act of 1986. The restrictions are also contrary to the goals of the Energy Policy Act of 1992, and will impermissibly infringe upon the historical and fundamental right of the citizens of their locale to act as a community and utilize their own best judgment in the provision of essential governmental services.

The Clinton administration should be commended for tackling this difficult issue. We are encouraged to see the administration proposal seek to "modify" and revise tax-exempt bond rules as part of electric utility restructuring "so that consumers benefit from competition." As we understand it, the proposal, to encourage public power systems to implement retail competition, states that outstanding bonds previously issued to finance generation and distribution facilities would continue their tax-exempt status "even if the issuer implements retail competition." Similarly, bonds issued to finance transmission facilities would also continue their tax-exempt status "even if private use resulted from allowing nondiscriminatory open access" to those facilities, including, for example, participation in an independent system operator (ISO).

However, the same proposal seems to prohibit public power systems from building both generation and transmission facilities in the future with tax-exempt bonds ("...interest on bonds...would not be exempt"). While we fully appreciate the political debate surrounding this issue, we are particularly concerned about the essence of this provision: community owned electric systems, especially the majority of the small systems around this country, could no longer exercise their right at local control and regulation, and may be unnecessarily burdened by an overly restrictive proposal.

We have expressed similar concerns directly to the administration. In a February 3 letter to Secretary of Energy Bill Richardson, the Alliance asked the administration to review its policy in this area. The transmission provision may be particularly troubling. While the generation side of the electric industry is currently undergoing a major transformation, the transmission side is not. For all the discussion about ISOs, regional transmission organizations, and transcos, several questions remain about transmission. For this reason, retaining the ability to issue tax-exempt debt for transmission facilities is critical to the future of community owned electric systems.

THE BOND FAIRNESS AND PROTECTION ACT

A similar legislative proposal has been offered in both the House and Senate. The Bond Fairness and Protection Act—introduced in the 106th Congress by Senators Slade Gorton and Bob Kerrey in the Senate (S. 386), and by Representatives. J. D. Hayworth and Bob Matsui in the House (H.R. 721)—is a fair and reasonable solution to the problems posed by the private use restrictions on public power bonds.

The bills, companion measures in both houses, provide state and locally owned utilities with two options for obtaining the necessary level of relief they need to enter competitive electricity markets without jeopardizing the tax-exempt status of outstanding bonds or raising rates. The bill also requires those taking this relief to make significant concessions on the future use of tax-exempt bonds by giving up the right to issue such debt for generation facilities, but retaining the same right to issue debt in the future for transmission and distribution facilities.

We urge the Committee to incorporate H.R. 721 into the committee bill. Of great import to the Alliance, the measure also respects state and local authority by allowing those decisions to be made at the state and local level.

The Governors' Public Power Alliance appreciates the opportunity to submit this statement for the record. We look forward to working with the Committee on these and other matters.

INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC.
SERVICE BUREAU CONSORTIUM, INC.
February 26, 1999

The Honorable Bill Archer
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515–6348

The Honorable Charles Rangel
Ranking Member, Committee on Ways and Means
1106 Longworth House Office Building
Washington, D.C. 20515–6348

Dear Chairman Archer and Ranking Member Rangel:

The Administration's FY 2000 budget proposal contains a provision that would accelerate, from quarterly to monthly, the collection of most federal and state unemployment insurance (UI) taxes beginning in 2005. The Interstate Conference of Employment Security Agencies (ICESA) and the Service Bureau Consortium (SBC) strongly oppose this provision. A similar proposal was put forth in the Administration's FY 1999 Budget and was rejected by Congress.

ICESA is the national organization of state administrators of unemployment insurance, employment and training services, and labor market information programs. SBC is a non-profit trade association whose member companies are organizations that provide payroll processing and employment tax services to more than 800,000 employers, representing more than one-third of the private sector workforce. Together, these organizations represent both those who collect UI taxes and those who process the tax payments.

Imposing monthly collection of federal and state UI taxes is a burdensome device that accelerates the collection of these taxes to generate a *one time* artificial revenue increase for budget-scoring purposes and real, *every year* increases in both compliance costs for employers and collection costs for state unemployment insurance administrators. The Administration's proposal is fundamentally inconsistent with every reform proposal that seeks to streamline the operation of the UI system and with its own initiatives to reduce paperwork and regulatory burdens.

This proposal is even more objectionable than some other tax speed-up gimmicks considered in the past. For example, a proposal to move an excise tax deposit date forward by one month into an earlier fiscal year may make little policy sense, but it would not necessarily create major additional administrative burdens. The UI speed-up proposal, however, would result directly *in significant and continuing costs to taxpayers and to state governments*—tripling the number of required UI tax collection filings from 8 to 24 per affected employer each year.

The Administration implicitly recognizes that the added federal and state deposit requirements would be burdensome, at least for small business, since the proposal includes an exemption for certain employers with limited FUTA liability. Even many smaller businesses that add or replace employees or hire seasonal workers would not qualify for the exemption, however, since new FUTA liability accrues with each new hire, including replacement employees. This deposit acceleration rule makes no sense for businesses large or small, and an exemption for certain small businesses does nothing to improve this fundamentally flawed concept.

We both strongly support UI reform that simplifies the system and reduces the burden on employers and the costs of administration to the federal and state governments. Adopting the Administration's UI collection speed-up proposal, however, would take the system in exactly the opposite direction, creating even greater burdens than those which exist under the current system.

We urge you to reject the Administration's UI collection speed-up proposal and focus instead on proposals that would make meaningful system-wide reforms. Thank you for your consideration of our views on this important issue. Please do not hesitate to let us know if we can provide additional assistance.

Sincerely,

Interstate Conference of Employment Security Agencies, Inc.
Service Bureau Consortium, Inc.

cc: Members of the Committee on Ways and Means

Statement of Investment Company Institute

The Investment Company Institute (the "Institute")[1] submits for the Committee's consideration the following comments regarding proposals to (1) enhance retirement security, (2) exempt from withholding tax all distributions made to foreign investors in certain qualified bond funds, (3) require mandatory accrual of market discount, (4) increase the penalties under section 6721 of the Internal Revenue Code[2] for failure to file correct information returns, (5) tax partial liquidations of partnership interests, and (6) modify section 1374 to require current gain recognition on the conversion of a large C corporation to an S corporation.

I. *Retirement Security Initiatives*

The U.S. mutual fund industry serves the needs of American households saving for their retirement and other long-term financial goals. By permitting millions of individuals to pool their savings in a diversified fund that is professionally managed, mutual funds provide an important financial management role for middle-income Americans. Mutual funds also serve as an important investment medium for employer-sponsored retirement programs, including small employer savings vehicles like the new Savings Incentive Match Plan for Employees ("SIMPLE") and section 401(k) plans, and for individual savings programs such as traditional and Roth IRAs. As of December 31, 1997, mutual funds held over $1.59 trillion in retirement assets, including $774 billion held in qualified retirement plans.[3]

The Institute has long supported legislative efforts to enhance retirement savings opportunities for Americans; including legislation that would expand retirement savings opportunities, simplify retirement plan administration and enable individuals to more easily manage their retirement accounts. Therefore, with respect to the items in the Administration's FY 2000 budget proposal, we support those provisions that would make retirement savings more portable, thus enabling Americans to more easily manage their retirement savings, and those that would increase small employer retirement plan coverage. Nevertheless, we believe that the Administration's proposals should be modified and broadened in several respects. In particular, as discussed further below, we recommend that (1) the portability proposal be broadened to include 457 plans, (2) the portability proposal be revised to eliminate unnecessary burdens on IRA custodians and trustees, (3) the SIMPLE plan deferral limit be raised, (4) Congress repeal or modify costly regulations that discourage plan formation, such as the "top-heavy" rule, (5) Congress ensure that any new programs do not undermine successful programs already in existence, such as SIMPLE plans, and (6) Congress raise contribution limits for IRAs and employer-sponsored plans and allow older Americans to make "catch-up" contributions.

A. Retirement Account Portability

Background.—Because average job tenure at any one job is under 5 years,[4] individuals are likely to have at least several employers over the course of their careers. As a result, the portability of retirement plan assets is an important policy goal.

Under current law, an individual moving from one private employer to another, where both employers provide section 401(k) plan coverage, generally may roll over

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,446 open-end investment companies ("mutual funds"), 456 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.662 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

[2] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[3] "Mutual Funds and the Retirement Market," Fundamentals, Vol. 7, No. 2 (Investment Company Institute, July 1998).

[4] Debunking the Retirement Myth: Lifetime Jobs Never Existed for Most Workers, Employee Benefit Research Institute, Issue Brief No. 197 (May 1998).

his or her vested account balance to the new employer. Where an individual moves from a private employer to a university or hospital or to the government sector, however, such account portability is *not* permitted. The problem arises because each type of employer has its own separate type of tax-qualified individual account program. Neither the university's section 403(b) program nor the governmental employer's "457 plan" program may accept 401(k) plan money, and vice versa. Moreover, with the exception of "conduit IRAs," moving IRA assets into an employer-sponsored plan is prohibited.

Recommendation.—The Institute supports the Administration's legislative proposal to permit portability among different types of retirement plans. Such legislation would enable individuals to bring retirement savings with them when they change jobs, consolidate accounts and more readily manage retirement assets. However, the Administration's portability proposal should be expanded to permit rollovers of 457 plan amounts to 401(k) plans and 403(b) arrangements and vice versa.

In addition, the Institute believes that portability legislation should be administratively feasible. Therefore, the Institute does not support the Administration's proposal to require IRA trustees and custodians to track and report the basis related to after-tax rollovers. Currently, IRA trustees and custodians do not verify or track the tax nature of an IRA contribution; this proposal would impose new and burdensome administrative requirements on IRA trustees and custodians with respect to IRA contributions. A specific methodology and tax form already is being used to track basis in IRA accounts, and could be easily adopted for this purpose. Thus, there is no need to create a wholly new reporting and accounting regime.

With respect to its proposal regarding rollovers of IRAs to qualified plans and 403(b) arrangements, the Administration would limit eligibility to those individuals who have a traditional IRA and whose IRA contributions have all been deductible. The Institute recommends expansion of this eligibility provision to permit taxpayers who have made non-deductible IRA contributions to roll over IRA amounts to qualified plans or 403(b) arrangements. Specifically, Congress should permit the rollover of all pre-tax IRA amounts, including deductible contributions and earnings, to plans regardless of whether a taxpayer has ever made a non-deductible contribution to an IRA. The Institute supports similar IRA rollover proposals contained in H.R. 739, the "Retirement Account Portability Act of 1999," which was introduced by Representative Pomeroy (D–ND), and H.R. 1102, the "Comprehensive Retirement Security and Pension Reform Act of 1999," which was introduced by Representative Portman (R–OH) and Representative Cardin (D–MD).

B. Small Employer Retirement Plan Coverage

Background.—Retirement plan coverage is a matter of serious public concern. Coverage rates remain especially low among small employers. Less than one-half of employers with 25 to 100 employees sponsored retirement plans. The percentage is even lower in the case of employers with fewer than 25 employees. The enactment[5] of legislation creating SIMPLE plans was a major first step toward improving coverage, but more remains to be done.

Recommendations.—Congress should (1) improve the SIMPLE plan program for small employers by raising the salary deferral limitation, (2) lower the cost of the plan establishment and administration, especially for small employers, by eliminating or modifying regulations, such as the "top-heavy" rule and providing a tax credit for small employers establishing plans for the first time, and (3) assure that new small employer plan initiatives provide effective incentives for plan establishment and do not undermine currently successful programs.

1. *Raise the SIMPLE Plan Deferral Limitation*.—In 1996, Congress created the successful SIMPLE program. The SIMPLE is a simplified defined contribution plan available to employers with fewer than 100 employees. An informal Institute survey of its largest members found that as of March 31, 1998, approximately 63,000 SIMPLE IRA plans had been established by these firms, representing an increase of 47% during the first three months of 1998. Further, the Institute found that approximately 343,000 SIMPLE IRA accounts had been established as of March 31, 1998, representing an increase of approximately 61% from year-end 1997 figures. Most significantly, the informal survey demonstrated that virtually all (98%) of SIMPLE plan formation is among the smallest of employers—those with fewer than 25 employees. Indeed, employers with 10 or fewer employees represented about 90% of these plans. Thus, for the first time, significant numbers of small employers are able to offer and maintain retirement plans for their employees. We believe the

[5] In 1993, the most recent year for which data is available, only 19 percent of employers with fewer than 25 employees sponsored a retirement plan. EBRI Databook on Employee Benefits. Employee Benefit Research Institute, 1997.

SIMPLE plan works because it is, as its name states, simple. It is easy to implement and easy to understand and places little administrative burden on small employers.

Currently, however, an employee working for an employer offering the SIMPLE may save only up to $6,000 annually in his or her SIMPLE account while an employee in a 401(k) plan, typically sponsored by a mid-size or larger employer, is permitted to contribute up to $10,000. Congress can readily address this inequity by amending the SIMPLE program to permit participating employees to defer up to $10,000 of their salary into the plan, that is, up to the limit set forth at section 402(g) of the Internal Revenue Code. This change would enhance the ability of many individuals to save for retirement and, yet, would impose no additional costs on small employers sponsoring SIMPLEs.[6]

We also believe that the SIMPLE program would be more effective for employers of 25–100 employees if there were a salary-reduction-only formula option. Such an option has been proposed in H.R. 1102 and should be considered as part of any retirement program reform bill seeking to address small employer coverage rates.

2. *Repeal or Modify Unnecessary, Costly Regulations, Such as The Top-Heavy Rule, That Inhibit Small Employer Plan Formation.*—Congress could raise the level of small employer retirement plan formation if it reduced the cost of plan formation and maintenance. One way to reduce these costs is for the federal government to subsidize them. The Administration has proposed a "start-up tax credit" for small employers that establish a retirement plan in 2000. Such a tax incentive may induce certain small employers to establish retirement plans.

Another approach would be to seek the actual reduction of on-going plan costs attributed to regulation. For instance, a 1996 U. S. Chamber of Commerce survey showed that the "top-heavy" rule[7] is the most significant regulatory impediment to small businesses establishing a retirement plan.[8] Repeal or modification of the "top-heavy" rule would likely lead to additional small employer plan formation.

Finally, Congress certainly should avoid discouraging plan formation by adding to the cost of retirement plans. Thus, the Institute strongly urges that Congress *not* enact the Administration's recommendation that a new mandatory employer contribution be required of employers using design-based safe harbor formulas in their 401(k) plans.

3. *New Programs For Small Employers Should Provide Effective Incentives For Plan Establishment and Not Undermine Currently Successful Programs.*—The Administration has also proposed enhancing the "payroll deduction IRA" program and creating a new simplified defined benefit plan program for small employers. In considering these proposals, it is important to assure that incentives are appropriately designed to induce program participation and that the programs do not undermine current retirement plan options.

For instance, the Administration would create an additional incentive to use the payroll deduction IRA program by excluding payroll deduction contributions from an employee's income. Accordingly, they would not be reported on the employee's Form W–2. As the success of the 401(k) and SIMPLE programs demonstrate, payroll deduction provides an effective, disciplined way for individuals to save, and its encouragement is a laudable policy goal. However, simplifying tax reporting alone may not provide a sufficient incentive for employers to establish a payroll deduction IRA program. More importantly, the interaction of an expanded payroll deduction IRA program with the new and successful SIMPLE program should be carefully considered. As noted above, the SIMPLE plan program has been extremely attractive to the smallest employers, exactly those for whom a payroll deduction IRA program is designed. Any new program expansion should not undermine this already existing, successful small employer program. Because the maximum IRA contribution amount is $2,000 (an amount not increased since 1981), it may not be appropriate to induce small employers to use that program rather than the popular SIMPLE program, which would permit employees a larger plan contribution. Similar considerations should be made with regard to any simplified defined benefit program.

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[6] As noted below, we also believe that the limits under section 402(g) should be raised.

[7] Section 416 of the Internal Revenue Code. The "top-heavy" rule requires employers, in situations where over 60 percent of total plan assets represent benefits for "key" employees, to (1) increase the benefits paid to non-key employees, and (2) accelerate the plan's vesting schedule. Small businesses are more likely to have individuals with ownership interests working at the company and in supervisory or officer positions, each of which are considered "key" employees, thereby exacerbating the impact of the rule.

[8] Federal Regulation and Its Effect on Business—A Survey of Business by the U.S. Chamber of Commerce About Federal Labor Employee Benefits, Environmental and Natural Resource Regulations, U.S. Chamber of Commerce, June 25, 1996.

C. Permit Individuals to Save Adequate Amounts for Retirement by Raising Contribution Limits, Including The IRA Limit

Many individuals cannot save as much as they need to under current retirement plan caps. An item notably absent from the FY 2000 budget proposal is a proposal to raise the contribution limits applicable to qualified plans and IRAs. Most significantly, the IRA limit remains at $2,000—a limit set in 1981. If adjusted for inflation, this limit would be at about $5,000. IRAs are especially important for individuals with no available employer-sponsored plan, who are significantly disadvantaged.

Similarly, we believe other retirement plan limits, such as the section 402(g) limit on salary deferrals and the section 415 limit on defined contribution plan contributions should be raised. These limits should also be adjusted to reflect the typical work and saving patterns of most Americans. Many Americans find it difficult to save for retirement when they have more pressing financial obligations, including purchasing a home, raising a family and providing college education for their children. All of these circumstances reflect the need to create a "catch-up" rule for employer-sponsored plans and IRAs whereby individuals age 50 and older can increase their annual contributions. All of these proposals, which are strongly supported by the Institute, are contained in H.R. 1102.

II. *Withholding Tax Exemption for Certain Bond Fund Distributions*

Background

Individuals around the world increasingly are turning to mutual funds to meet their diverse investment needs. Worldwide mutual fund assets have increased from $2.4 trillion at the end of 1990 to $7.6 trillion as of September 30, 1998. This growth in mutual fund assets is expected to continue as the middle class continues to expand around the world and baby boomers enter their peak savings years.

U.S. mutual funds offer numerous advantages. Foreign investors may buy U.S. funds for professional portfolio management, diversification and liquidity. Investor confidence in our funds is strong because of the significant shareholder safeguards provided by the U.S. securities laws. Investors also value the convenient shareholder services provided by U.S. funds.

Nevertheless, while the U.S. fund industry is the global leader, foreign investment in U.S. funds is low. Today, less than one percent of all U.S. fund assets are held by non-U.S. investors.

One significant disincentive to foreign investment in U.S. funds is the manner in which the Code's withholding tax rules apply to distributions to non-U.S. shareholders from U.S. funds (treated for federal tax purposes as "regulated investment companies" or "RICs"). Under U.S. law, foreign investors in U.S. funds receive less favorable U.S. withholding tax treatment than they would receive if they made comparable investments directly or through foreign funds. This withholding tax disparity arises because a U.S. fund's income, without regard to its source, generally is distributed as a "dividend" subject to withholding tax.[9] Consequently, foreign investors in U.S. funds are subject to U.S. withholding tax on distributions attributable to two types of income—interest income (on "portfolio interest" obligations and certain other debt instruments) and short-term capital gains—that would be exempt from U.S. withholding tax if received directly or through a foreign fund.

A U.S. fund may "flow through" the character of the income it receives only pursuant to special "designation" rules in the Code. One such character preservation rule permits a U.S. fund to designate distributions of long-term gains to its shareholders (both U.S. and foreign) as "capital gain dividends." As capital gains are exempt from U.S. withholding tax, foreign investors in a U.S. fund are not placed at a U.S. tax disadvantage with respect to distributions of the fund's long-term gains.

Legislation introduced in both the House and the Senate in every Congress since 1991, and most recently in 1997,[10] would permit all U.S. funds also to preserve, for withholding tax purposes, the character of interest income and short-term gains that would be exempt from U.S. withholding tax if received by foreign investors directly or through a foreign fund. The Institute strongly supports these "investment competitiveness" bills.

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[9] The U.S. statutory withholding tax rate imposed on non-exempt income paid to foreign investors is 30 percent. U.S. income tax treaties typically reduce the withholding tax rate to 15 percent.

[10] The "Investment Competitiveness Act of 1997" was introduced by Representatives Crane, Dunn and McDermott (as H.R. 707) and by Senators Baucus, Gorton and Murray (as S. 815).

Proposal

The President's Fiscal Year 2000 budget proposal, like the 1999 budget proposal, includes a provision that generally would exempt from U.S. withholding tax all distributions to foreign investors by a U.S. fund that invests substantially all of its assets in U.S. debt securities or cash.[11] A fund's distributions would remain eligible for this withholding tax exemption if the fund invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries. Importantly, the taxation of U.S. investors in U.S. funds would *not* be affected by the proposal.

Recommendation

The Institute urges the Committee to support enactment of legislation broader than that proposed by the Administration. Specifically, such legislation would exempt from U.S. withholding tax all distributions by U.S. funds—including equity, balanced and bond funds—of interest and short-term capital gains to foreign investors that would be exempt if received by a foreign investor either directly or through a foreign fund.[12] Such legislation would eliminate U.S. tax incentives for foreign investors to prefer foreign funds over U.S. funds. Providing comparable withholding tax treatment for *all* U.S. funds would enhance the competitive position of U.S. fund managers and their U.S.-based work force.

Should the Committee determine to support the Administration's narrower proposal, which is limited to U.S. bond funds, the Institute recommends that such legislation distinguish between "tax-exempt" and "taxable" foreign securities. Specifically, no limit should be placed on the ability of a U.S. fund to hold a foreign bond, such as a Eurobond,[13] that is exempt from foreign tax in the hands of a U.S. investor pursuant to the domestic law of the relevant foreign country (a "tax-exempt" foreign bond). In contrast, strict limits should be placed on the ability of a U.S. fund to hold a foreign bond that would be subject to foreign tax in the hands of a U.S. investor but for an income tax treaty with the United States (a "taxable" foreign bond). Such an approach was followed in legislation introduced last year that was drafted to reflect the Administration's Fiscal Year 1999 budget proposal.[14]

III. *Mandatory Accrual of Market Discount*

Background

Market discount generally is defined as the excess of the principal amount of a debt instrument (or the adjusted issue price in the case of a debt instrument issued with original issue discount[15] over a holder's basis in the debt instrument immediately after acquisition. A bond typically will trade in the secondary market at a price below its principal amount (and hence with market discount) because an increase in interest rates after the date the bond was issued has reduced its value.[16] Assuming no further changes in interest rates or in the creditworthiness of the issuer, the market value of a bond purchased with market discount would increase on a consistent yield basis until its maturity date.

Current law generally does not require any taxpayer—whether the taxpayer determines income on a cash or an accrual basis—to take market discount accruals into taxable income until the date the bond matures or is sold.[17] Upon disposition, the amount of gain on a market discount bond, up to the amount of the accrued

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[11] The proposal would be effective for taxable years beginning after the date of enactment.

[12] This legislation should contain appropriate safeguards to ensure that the exemption (1) applies only to interest that would be exempt from U.S. withholding tax if received by a foreign investor directly or through a foreign fund and (2) does not permit foreign investors in U.S. funds to avoid otherwise-applicable foreign tax by investing in U.S. funds that qualify for treaty benefits under the U.S. treaty network.

[13] "Eurobonds" are corporate or government bonds denominated in a currency other than the national currency of the issuer, including U.S. dollars. Eurobonds are an important capital source for multinational companies.

[14] The "International Tax Simplification for American Competitiveness Act of 1998" was introduced in the House by Representatives Houghton, Levin and Crane (as H.R. 4173) and in the Senate by Senators Hatch and Baucus (as S. 2331).

[15] Original issue discount ("OID") is defined generally as the excess of a debt instrument's stated redemption price at maturity over its issue price. The total amount of OID on a debt instrument generally does not change over the period the debt instrument is outstanding.

[16] A decline in the creditworthiness of an issuer also may cause a bond to trade in the secondary market at a discount.

[17] Partial principal payments on a market discount bond are included as ordinary income to the extent of accrued market discount. Holders also may elect to take market discount accruals into income currently.

market discount, is taxed as ordinary income; any excess amount is treated as capital gain. Among the reasons for not taking market discount accruals into income on a current basis are that market discount (1) arises from market changes that affect the yield of a bond rather than from the terms of the bond itself, (2) may not be realized in part or in whole by any holder disposing of a bond prior to maturity,[18] and (3) can be difficult to compute.

Proposal

Under the President's Fiscal Year 2000 budget proposal, accrual basis taxpayers would be required to include market discount in income currently, i.e., as it accrues.[19] The holder's yield for market discount purposes would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus five percentage points or (2) the applicable Federal rate (at the time the holder acquired the debt instrument) plus five percentage points. Importantly, the proposal would not apply to cash basis taxpayers, such as individuals.

Recommendation

The Institute urges the Committee to reject the proposed requirement that accrual basis taxpayers, such as RICs, currently include in taxable income their market discount accruals. First, the proposal would accelerate the inclusion of market discount in the RIC's taxable income without the receipt of any cash that could be used by the RIC to meet its distribution obligations to its shareholders.[20] Second, the proposal would result in over-inclusions of taxable ordinary income to the extent that a bond purchased with market discount is sold for an amount that is less than the purchase price plus accrued market discount. These results are particularly inappropriate for a RIC's individual shareholders, who would experience neither income acceleration nor over-inclusion of market discount if they were to make comparable investments directly.

Example

To illustrate these effects, assume a bond with a principal amount of $10,000 and a five percent coupon payment that has five years to maturity. Further assume that a RIC acquires this bond for $9,000 and holds it for three years. Finally, assume that interest rate fluctuations between the date the bond was acquired by the RIC and the date the bond was sold were such that the value of the bond, at disposition, was only $9,500.

Under current law, the RIC accrues $200 of market discount each year, but need not include the accruals in income until the year of sale.[21] Upon disposition, the RIC would treat the $500 gain ($9,500 proceeds less $9,000 basis) as ordinary income.

As the proposal would not apply to cash basis taxpayers, an individual that held the market discount bond directly would continue to receive the same tax treatment that the RIC receives under current law; prior to disposition, no amounts would be includible in taxable income.

In contrast, the proposal would require the RIC to treat the $200 accrual in each of the three years as ordinary income, which must be distributed currently by the RIC to its shareholders. Upon disposition, at which time the RIC's cost basis has been increased to $9,600 (to reflect the $600 of market discount included in income), the RIC would have a $100 capital loss. This loss could be used by the RIC to offset capital gain at the RIC level, but could not be "flowed through" to the RIC's shareholders.[22]

The proposal also should be rejected because of the potential negative impact on the liquidity of bonds (tax-exempt bonds, in particular) in any interest rate environment in which existing bonds would trade at a significant discount to principal

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[18] The amount that ultimately will be received upon the sale of a bond depends, among other things, upon future changes in interest rates. If interest rates increase, bonds purchased with market discount may be sold at a loss; in this case, none of the accrued market discount ever is realized.

[19] The proposal would apply to debt instruments acquired on or after the date of enactment.

[20] Under section 852(a), a RIC must distribute at least 90 percent of its ordinary income with respect to its fiscal year to qualify for treatment under Subchapter M of the Code. In addition, under section 4982, a RIC will incur an excise tax unless it distributes by December 31 essentially all of its calendar year ordinary income (and capital gain through October 31).

[21] Alternatively, a RIC could elect to accrue the market discount on a "constant yield" basis under section 1276(b)(2).

[22] RICs may not flow through capital losses to their investors, pursuant to Subchapter M of the Code. Capital losses may be carried forward for eight years, pursuant to section 1212(a)(1)(C)(i). In recent years, some RICs investing in bonds have been unable to generate sufficient capital gains to offset losses carried forward before they expired.

amount. Because of the potential negative tax consequences of purchasing market discount bonds (e.g., accelerated inclusion of ordinary income and capital losses in the event of subsequent interest rate increases), RICs and other accrual basis taxpayers might have strong incentives to buy only newly-issued bonds.

IV. *Increased Penalties for Failure to File Correct Information Returns*

Background

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000.[23] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

Proposal

The President's Fiscal Year 2000 budget contains a proposal that would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported.[24] The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

Recommendation

The Institute urges the Committee to reject the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of serious concern to RICs. Significant effort is devoted to providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

The Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[25] The current penalty structure provides adequate, indeed very powerful, incentives for RICs to promptly correct any errors made.

V. *Partial Liquidations of Partnership Interests*

Background

Under current law, a partial liquidation of a partnership interest is taxable only to the extent that any cash distributed exceeds the partner's adjusted basis in its partnership interest immediately before the distribution. Thus, in the case of a "master/feeder fund structure,"[26] a RIC feeder fund partner typically may liquidate a portion of its interest in the master fund partnership in the ordinary course of its business without incurring capital gain on its underlying investment in the partnership. A RIC feeder fund will partially liquidate its interest in the master fund partnership on any day in which it needs to generate cash to meet shareholder redemptions.[27]

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[23] Failures attributable to intentional disregard of the filing requirement generally are subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

[24] The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

[25] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

[26] The master/feeder structure has developed as a vehicle pursuant to which RICs (known as "feeder funds") generally invest substantially all of their assets in one partnership (known as the "master fund"). On occasion, institutional investors or other entities also may be feeder funds.

[27] RIC feeder funds typically are structured as open-end investment companies, the shares of which are redeemable upon shareholder demand pursuant to the Investment Company Act of 1940. On occassion, RIC feeder funds also may be structured as "interval funds," which issue shares that are redeemable on a periodic, rather than daily, basis.

Proposal

Under the President's Fiscal Year 2000 budget proposal, a partial liquidation of a partner's interest in a partnership would be taxed as a complete liquidation of that portion of the partner's interest.[28] Gain or loss on the partial liquidation would be determined by allocating the distributee partner's basis ratably over the portions of the partnership interest that are liquidated and retained. The rationale for the proposed change, according to the Treasury Department's "General Explanations of the Administration's Revenue Proposals," is that the current law rules "provide for an inappropriate deferral of gain."

Recommendation

Should the Committee decide to expand the circumstances in which partial liquidations of partnership interests are taxed, the Institute urges the Committee not to apply the change to RIC feeder fund investments in master funds. This exception should be made because the rationale for the proposal—to prevent deferral—simply does not apply.

Under current law, the shareholder in a RIC feeder fund whose redemption request triggers the RIC's need for cash, and hence the partial liquidation of the RIC's interest in the master fund partnership, already is required to take into account currently any gain—attributable to appreciation in the value of the shareholder's investment, through the RIC, in the master fund partnership—on the shares redeemed. The existing basis calculation rules of section 1012 and share redemption rules of section 302 apply to prevent deferral.

The only impact of applying this proposal to master/feeder funds would be to require a taxable distribution by a RIC feeder fund of gains to its *non-redeeming* shareholders, who did not trigger the partial liquidation.[29] This result would be unfair and presumably is unintended. Consequently, should the Committee determine to pursue the Administration's proposal, an exception for the master/feeder fund structure should be adopted.

VI. *Conversions of Large C Corporations to S Corporations*

Background

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on any asset that is held at the time of the conversion and sold within 10 years. In Notice 88–19, 1988–1 C.B. 486, the IRS announced that regulations implementing repeal of the so-called General Utilities doctrine would be promulgated under section 337(d) to provide that section 1374 principles, including section 1374's "10-year rule" for the recognition of built-in gains, would be applied to C corporations that convert to regulated investment company ("RIC") or real estate investment trust ("REIT") status.

Notice 88–19 was supplemented by Notice 88–96, 1988–2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88–96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis.

Proposal

The President's Fiscal Year 2000 budget proposes to repeal section 1374 for large corporations.[30] For this purpose, a corporation is a large corporation if its stock is

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[28] The proposal would apply to certain partial liquidations made after date of enactment. From a discussion with a Treasury Department official, we understand that the proposal is not intended to be applied on a daily basis.

[29] The distribution requirements applicable to RICs require that dividends be declared ratably to all RIC shares outstanding on the date the dividend distribution is declared. Unlike the rules applicable to partnerships, no ability exists to specially allocate the gain to the redeeming RIC shareholder.

[30] The proposal to repeal section 1374 for large corporations would apply to Subchapter S elections first effective for a taxable year beginning after January 1, 2000 and to acquisitions (e.g., mergers) after December 31, 1999.

valued at more than five million dollars at the time of the conversion to an S corporation. Thus, a conversion of a large C corporation to an S corporation would result in gain recognition both to the converting corporation and its shareholders. The proposal further provides that Notice 88–19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in the immediate recognition of the corporation's net built-in gain. Thus, the Notice, if revised as proposed, no longer would permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

Recommendation

Because the safe harbor set forth in Notice 88–96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation should have no effect on Notice 88–96. The safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that requalifies under Subchapter M after failing to qualify for a single year would be inappropriate. Moreover, the imposition of tax in such a case would fall directly on the RIC's shareholders, who typically are middle-income investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88–19 are not intended to impact the safe harbor provided by Notice 88–96.

Should this proposal be adopted, the Institute recommends that the legislative history include a statement, such as the following, making it clear that the proposed revision to section 1374 and the related change to Notice 88–19 would not impact the safe harbor set forth in Notice 88–96 for RICs that fail to qualify for one taxable year:

> This provision is not intended to affect Notice 88–96, 1988–2 C.B. 420, which provides that regulations to be promulgated under section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88–19, 1988–1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88–96.

Statement of Large Public Power Council

I. INTRODUCTION

We appreciate the opportunity to submit this written statement for the record of the Committee on Ways and Means hearing on the revenue provisions in the President's FY 2000 Budget. We are the Large Public Power Council (the "LPPC"), an organization composed of 21 of the nation's largest locally-owned and controlled power systems. A list of our members is attached as an appendix to this statement. LPPC members directly and indirectly provide reliable, high-quality, low-cost electricity to more than 40 million people. This includes tens of thousands of large and small businesses located in some of the faster-growing urban and rural residential and commercial markets in America. Like their approximately 2000 smaller public power counterparts located in every state but Hawaii, LPPC's members are not-for-profit entities committed only to the people and communities they serve.

We are pleased to see that the President's FY 2000 Budget includes the proposals that the Administration originally made last year relating to the tax aspects of electricity deregulation. As we stated last year both when the temporary regulations on private use were issued and when the comprehensive electricity restructuring proposal was unveiled, the LPPC supports the Administration's efforts to address, in a rational and equitable way, the tax issues raised by electricity deregulation.

We believe, however, that improvements can be made to the President's approach to resolving these tax issues. In this statement, we will outline the tax issues created for publicly-owned utilities in a deregulated environment, discuss the President's solution to these problems, and propose an alternative bipartisan compromise that may better address those problems.

II. TAX ISSUES IN ELECTRICITY DEREGULATION

Publicly-owned utilities have operated up to now under a strict regime of Federal tax rules governing their ability to issue tax-exempt bonds. Under current Federal tax law, interest on state and local government bonds generally is excluded from income if the bonds are issued to finance governmental activities. Facilities for electric generation, transmission, and distribution are eligible for financing with tax-exempt bonds when the financed facilities are used by or paid for by a state or local governmental entity. Generally, bond-financed facilities are used for a governmental purpose even when the electricity they generate or transmit is sold to private persons provided those persons are treated as members of the general public. The so-called "private use" rules limit the amount of power that publicly-owned utilities may sell to private entities through facilities financed with tax-exempt bonds.

For years, the private use rules were cumbersome but manageable. These rules, however, were enacted in an era that did not contemplate electricity deregulation. As states deregulate, the private use rules are threatening many communities that are served by public power with significant financial penalties as they adjust to the changing marketplace. While Federal deregulation legislation has yet to be enacted, eighteen states have already gone forward and begun to deregulate electricity at the state and local level. The era of competition has already begun in those states.

With competition, publicly-owned utilities face some difficult choices. In order to develop efficient nondiscriminatory transmission services, publicly-owned utilities will be required to turn operation of their transmission facilities over to independent systems operators or otherwise use those facilities in a manner that may violate the private use rules. As traditional service areas of both investor-owned and publicly-owned facilities are opened to retail competition, publicly-owned utilities may find it necessary to enter into contracts with private users of electricity in order to prevent their generation facilities from becoming stranded costs and to be able to pay debt service on their bonds. For instance, when electricity is sold under long-term contracts to private persons, the private use restrictions of the Internal Revenue Code may render the interest on outstanding bonds taxable.

In effect, publicly-owned utilities face the prospect of violating the private use rules, or walling off their customers from competition: in either case consumers would experience higher rates—the precise opposite of what deregulation is supposed to achieve. The consumer can only lose when this happens.

III. THE PRESIDENT'S PROPOSALS ON THE TAX ISSUES RELATED TO ELECTRICITY RESTRUCTURING

A. Treasury regulations

In January 1998, the Treasury and the Internal Revenue Service ("IRS") issued temporary and proposed regulations relating to the rules for generation, transmission, and distribution of electricity with facilities financed with tax-exempt bonds. These rules provide limited relief, within the context of present law, from the application of the private use rules in a deregulated environment. Because these regulations are temporary, they expire three years after publication unless the IRS finalizes or reissues them.

We applaud the Administration's efforts to afford publicly-owned utilities some opportunity to participate in a deregulated market. However, the regulations fail to address some serious problems, including the ability of publicly-owned utilities to meet the needs of existing customers. Further, as noted above, they are temporary, and unless finalized, will expire in less than two years (January 22, 2001). Thus, we concur with the Administration that legislative action is needed to address the private use problem facing publicly-owned utilities.

B. The Administration's FY 2000 budget proposals

On March 24, 1998, the Department of Energy announced the Administration's Comprehensive Electricity Competition Plan. Included in the plan were revisions to the tax rules governing private use of tax-exempt bond-financed electric facilities. The President has included these tax proposals in his FY 2000 Budget submission.

These proposals are several. First, the Administration proposal would bar the use of tax-exempt bonds for new facilities for electric generation and transmission.

Distribution facilities could continue to be financed with tax-exempt bonds subject to the existing private use rules. Second, the Administration proposal would grandfather existing tax-exempt bonds from the private use rules if the bonds were used to finance: (1) transmission facilities the private use of which results from a FERC order requiring non-discriminatory open access to those facilities; or (2) generation or distribution facilities the private use of which results from retail competition or a contract effective after implementation of retail competition. The proposal would permit current, but not advance, refunding, of bonds issued before date of enactment of The Administration's Comprehensive Electricity Competition Plan.

In addition, the Administration includes a proposal to accommodate the need in a deregulated environment of investor-owned utilities with nuclear facilities for modification of the treatment of contributions to nuclear decommissioning funds.

LPPC applauds these proposals as rational and equitable attempts to address the problems faced by utilities in a deregulated environment. In the case of publicly-owned utilities, the Administration would provide relief from the application of the private use rules; in the case of certain investor-owned utilities, it would make workable the provision governing the treatment of contributions to nuclear decommissioning funds. We believe, however, that there is an alternative approach that better addresses the different situations in which the various publicly-owned utilities may find themselves.

IV. THE BOND FAIRNESS AND PROTECTION ACT: AN ALTERNATIVE BIPARTISAN COMPROMISE APPROACH

The LPPC urges the Committee to consider an alternative approach to the private use issue, one that is supported by a bipartisan group of Members and Senators, the Bond Fairness and Protection Act of 1999 (H.R. 721 in the House and S. 386 in the Senate). This legislative proposal would provide publicly-owned utilities with an option: they can continue to issue tax-exempt bonds for generation transmission and distribution facilities under a set of private use rules clarified to provide a modest set of changes to deal with deregulation, or they can elect to forego the ability to issue tax-exempt bonds for new generation facilities, but with a grandfather of their existing tax-exempt bonds from the adverse application of the private use rules.

The clarifications to the private use rules proposed in the legislation are intended to accommodate the reality of operating in a deregulated market, nearly all of which were recognized by Treasury in the relief provided in its temporary regulations. Private use would not include certain “permitted open access transactions.” The bill lists the following activities as permitted open access transactions: (1) providing open access transmission service consistent with FERC Order No. 888 or with state open transmission access rules; (2) joining an FERC-approved ISO, regional transmission group (RTG), power exchange, or in accordance with an ISO, RTG, or power exchange tariff; (3) providing open access distribution services to competing retail sellers of electricity; or (4) if open transmission or distribution services are offered, contracting for sales of power at non-tariff rates with on-system purchasers or existing off-system purchasers.

Only the last of these clarifications is new and would merely permit publicly-owned utilities to enter into long-term contracts with their existing customers, a change that is essential if these utilities are to compete with other electric providers for these customers. In fact, this change would merely give publicly-owned utilities the same ability to contract with their customers as the investor-owned “two county” utility that benefit from tax-exempt bonds have. Moreover, given the changing nature of how electricity is being sold, a publicly-owned utility should not have to give up the ability to issue tax-exempt bonds merely in order to contract or to provide service to its historic customers.

The advantage of this approach is that it provides needed flexibility to public utilities; if a public utility wants to participate in the competitive market generally it will need to give up its ability to issue tax-exempt bonds in the future, thereby mitigating any perception of a competitive advantage. If a public utility is not interested in competing in the open market or has little outstanding debt, it need not make the election. Moreover, this approach links the availability of relief from the retroactive application of the private use rules to outstanding tax-exempt bonds with a willingness to forego the ability to issue tax-exempt debt in the future for generation facilities.

The Bond Fairness and Protection Act of 1999 has attracted the support of a diverse group of organizations including, for example, from the private sector, the Independent Energy Producers, and from the public sector, the National League of Cities. Similarly, the Government Finance Officers Association has endorsed the need for private use relief of the type contained in this bill.

V. CONCLUSION

Again, Mr. Chairman, we appreciate this opportunity to present our views on the electricity restructuring provisions in the President’s FY 2000 Budget. We urge the Committee to act this year to provide much needed relief from the unintended application of the private use restrictions of the Internal Revenue Code to publicly-owned utilities struggling to adapt to the changing marketplace while continuing to serve their customers by providing cheap and reliable electricity. The marketplace is not waiting for Federal legislation to force deregulation; it is happening now in numerous states and localities around the country. But only Congress can change the Federal tax rules that are hampering the ability of publicly-owned and controlled utilities to provide the services on which consumers depend.

We would be happy to assist the Committee in any way possible as you consider the tax issues related to electric deregulation.

Statement of M Financial Group, Portland, Oregon

INTRODUCTION

The President's FY 2000 budget proposal calls for increases in taxes and treatment of life insurance policyholders and life insurance companies that would discourage long-term savings and private responsibility for financial security for American families.

Undermines Individual's Ability to Save

At a time when Americans need to save and plan more for their retirement, several provisions of the budget would prevent life insurance products from continuing to provide effective solutions to long-term benefit, savings, and retirement security needs. This unfortunate proposal drastically undermines the government's decades-long policy of encouraging individuals and businesses to provide for their own and their employees' financial security. At a time when the long-term national savings rate is at an all time low and with the prospect of increased pressure on social security, the President's budget takes away several key methods of providing for that financial security. In many cases, the proposals result in a retroactive tax increase on middle-class working Americans.

Ten Percent Tax Increase

The proposals affecting the life insurance industry, taken together, represent an almost 10 percent increase in the taxes paid annually by the life insurance industry. In the FY 2000 Budget, Treasury continues to pursue an unfair and unwarranted attack on the life insurance industry and the products it provides which benefit the financial security of millions of Americans.

Proposals of Particular Concern

COLI Proposal—Increases taxation on companies that own life insurance policies on their employees and officers. This tax increase could significantly reduce the level of funding for employee-related benefits, undermining employee security associated with these benefits and the financial protection of families and businesses. The proposal particularly hurts small businesses which rely on life insurance policies to provide benefits and incentives to their employees. The proposal's characterization of COLI as a corporate tax avoidance scheme that represents a loophole in the Internal Revenue Code is particularly objectionable.

Proposal to Modify Rules for Capitalization of Policy Acquisition Costs of Life Insurance Companies—Increases the cost of life insurance and annuity products by increasing the tax burden on these products. The administration proposes a two-thirds increase in the federal tax cost associated with life insurance products and a *three-fold increase* for annuity products. If enacted, the new taxes will end up being an added cost passed through to policyholders. This hurts all Americans who rely on insurance products to provide financial security for their family by raising the cost of providing that protection.

Continued Unfair Targeting of the Life Insurance Industry

We believe that these proposals, together with the other proposals that target the insurance industry, such as the required recapture of policyholder surplus, need to be reviewed in light of the fact that *the insurance industry is already one of the most highly taxed industries in America*. A recent Coopers & Lybrand study reveals that insurers pay an average effective tax rate of 37 percent, as opposed to the 24 percent paid by all other U.S. corporations studied over the same time period. Yet, Treasury continues to single out the insurance industry for attack. If these attacks go unchecked, they will ultimately threaten the financial strength and solvency of the industry and the financial protection that it provides to millions of families.

Threat to the Solvency of the Insurance Industry

By increasing costs associated with insurance products, these proposals ultimately could pose a threat to the capital base and solvency of the industry, an industry which employs and supports millions of Americans. Particularly hard hit would be U.S. small businesses and insurance company employees.

Revenue Effects Uncertain

Perversely, these proposals might even *reduce* current levels of tax revenue generated as a result of the reduced purchase of insurance products and a commensurately adverse offset of insurance company income.

In summary, these provisions are unsound and illogical. They threaten to discourage long term savings, further eroding individual responsibility for providing financial protection and security for the future. They threaten to destabilize the financial condition of life insurance companies by disproportionately taxing the industry, which would affect millions of existing policyholders and insurance company employees.

M FINANCIAL GROUP

M Financial Group is a marketing and reinsurance organization comprised of over 100 independently owned firms, located across the country, that focus on providing financial security and solutions to the estate and benefit planning needs of individuals and businesses.

Collectively, these firms manage life insurance policies in force for their clients representing over $2 billion of annual life insurance premiums, over $12 billion of policyholder account values, and over $45 billion of total death benefit protection.

Multitude of Benefits

These insurance arrangements enhance individual Americans' financial security by

• Allowing businesses an effective vehicle to fund benefit liabilities for employee retirement income payments, salary continuance for employees' spouses, and other post-retirement benefits.

• Providing for financial liquidity to families at time of death to pay estate taxes. Many families' assets are in illiquid forms such as family-owned real estate or small businesses. Life insurance helps families meet their estate tax and business continuity needs without having to sell the underlying asset. Life insurance provides a liquid source of funds to meet the liability without disrupting families, allowing small businesses to continue into the next generation and provide jobs to their employees.

• Providing business with a financial means to continue operation upon death of a key executive, during the period when it is seeking to replace the key individual.

• Giving individuals the ability to provide survivors with death benefit protection while supplementing retirement savings.

Life Insurance Provides Many Advantages

Life insurance is a particularly effective and efficient vehicle to defray the costs of these benefits while encouraging savings. It helps provide individuals and employers with a source of future income to offset various unpredictable future needs, such as untimely death or long-term medical needs. Given the economic realities the nation faces in having to fix Social Security to support the retirement of the baby boom generation, insurance offers an excellent product that helps match the need for savings and the need for financial protection. The impact of the proposal on the ability to use life insurance on all of these areas is devastating.

Retroactive Tax Provisions Make Bad Policy

In addition, the proposed retroactive application of the provisions to policies already purchased and owned by millions of Americans thwarts effective tax-planning. A precedent of retroactive application of tax increases to existing contracts is inherently unfair and reduces the potential for the tax law to provide effective long-term incentives for establishing private savings programs.

We applaud the strong opposition to these proposals voiced by many Members of Congress. We are certain that upon closer examination of the facts and issues surrounding these proposals, the Members will reject this tax increase on the American public.

The balance of this document provides specific background on the impact of these proposals on certain uses of life insurance that help provide financial security to millions of Americans.

PROPOSAL: REPEAL OF THE EXCEPTION FOR EMPLOYEES, OFFICERS, AND DIRECTORS UNDER THE CORPORATE OWNED LIFE INSURANCE (COLI) PRORATION RULES.

Background:

COLI policies have long been used by businesses to enhance employee savings and provide retirement benefits. COLI helps promote the long-term financial security of employees and their families such as in the case of untimely death.

COLI Helps Companies Offer Employee Benefits

The need to use COLI to provide employee and retirement benefits arises from prior legislative initiatives such as ERISA, TEFRA, and DEFRA, which have limited a company's use of tax-qualified pension arrangements. Over time, these limitations have made the use of traditional pension arrangements more complex and less effective. Hit most hard by these limitations are middle-level executives, as defined by the Department of Labor. The compression on qualified plans and the corporate desire to restore such benefits has led to an increased reliance on nonqualified plans.

COLI Encourages Personal Savings

The use of nonqualified plans is an extremely effective vehicle for increasing the personal savings rate at a time when Americans are living longer and there is more uncertainty of the ability of other social programs to provide needed employee and retirement benefits. Nonqualified plans offer long-term benefits that give employees the means to provide themselves and their families with financial security. These plans have long-term emerging liabilities and actuarial risk, which are well-suited to funding with life insurance. This use of COLI serves an important social and economic purpose in helping to finance these plans.

Examples of Beneficial Programs Funded By COLI—

- Supplements retirement income and survivor benefits beyond those available under qualified plan limits. These benefits promote the financial security of millions of Americans.
- Enables employees to contribute after-tax dollars to enhance their retirement and survivor benefits.
- Allows businesses to provide benefits needed to attract and retain key employees.
- Supports the ability, particularly for small businesses, to withstand the significant financial loss resulting from the premature death of a key employee.
- Provides business continuity in circumstances that could otherwise result in failure and significant economic hardship for all employees.

COLI Useful to both Large and Small Corporations

Almost all public and an increasing number of small private U.S. companies use life insurance to provide some form of financial security and stability to the organization, the employees and their families. For many corporations, COLI is the tool of choice to manage effectively the liabilities related to employee death and retirement benefits. Defraying the costs of these liabilities with after-tax dollars in COLI policies is consistent with Federal retirement savings incentives and is good public policy.[1]

Effect of Proposal:

The changes to COLI increase current taxes for all businesses that own or are beneficiaries of a life insurance policy. This proposal would seriously curtail the availability of the benefits these policies provide and reduce personal savings. This proposal will limit the protection available to families and increase the risks to businesses due to premature death of an employee.

The proposed changes to IRC § 264 increase taxes by disallowing a portion of the company's interest deduction for unrelated debt. This proposal would affect all business uses of life insurance. To preserve the motivation and opportunity for private saving, it is important to preserve the ability for businesses to purchase life insurance to provide an array of benefits to their employees. At a time when Congress is increasing incentives for employee-based savings through the expansion of Roth

[1] The written statement addresses the negative impact of the Administration's Proposal on traditional COLI plans, and does not address Bank-Owned Life Insurance (BOLI). The use of COLI by financial institutions that borrow funds at low cost might raise issues apart from those discussed here. Because M Financial's business does not include the sale of BOLI products, we express no opinion on the propriety of such arrangements.

IRAs and other provisions, it is contradictory to tax the use of life insurance to fund the same benefits.

Current law already limits potential abuses in COLI applications used to defray the costs of the types of liabilities previously mentioned: Qualified plan limits restrict the amount of insurance that can be purchased by an employer on a currently deductible basis. IRC § 7702 and IRC § 7702A require corporate-owned policies to provide true death benefit protection. IRC § 264 prevents leverage arbitrage by prohibiting tax deductible borrowing against a corporate-owned life insurance policy. All these provisions combine to assure that COLI will be used to defray the costs of real benefit liabilities in a manner consistent with tax policy.

Unfortunately, the effect of the COLI proposal in the Administration's Budget would be to limit wholly appropriate business uses of life insurance—such as assuring that employees receive the retirement benefits they have been promised and are counting on getting—by making the cost of insurance products economically unfeasible. The proposal would unnecessarily deny the benefits of COLI to millions of Americans.

Moreover, the Administration's rationale for the COLI proposal is fundamentally flawed and unjustified. The Administration believes that allowing a taxpayer a deduction for interest incurred on indebtedness in the operation of a business is wrong if the business owns life insurance on its employees, even if the business indebtedness is entirely unrelated to the insurance. This belief flies in the face of fundamental principals of tax law, which allow for ordinary and necessary business expenses.

Under recent changes in current law, interest on indebtedness directly related or "traced" to corporate owned life insurance is already subject to disallowance. The new COLI proposal would go well beyond current law and deny deductions for interest that is completely unrelated to the insurance. This is not only unjustified, but is also overly broad and creates inequities between businesses that rely on debt financing and those that are equity financed.

In cases where a business provides insurance-financed benefit programs such as broad-based health coverage for retirees, nonqualified pensions, or other supplemental or survivor benefits, a "tax" would now be imposed if the business had any indebtedness on its books. This resulting "tax" would most likely cause the business to scale back its benefit programs, causing harm to the long-term health and security of its employees. Across the country, this would have a devastating impact on many small and mid-sized businesses who rely on insurance to fund such programs.

By indirectly "taxing" retirement and benefit programs, the COLI proposal is directly contrary to efforts by the Administration and Congress to provide incentives to increase U.S. savings (e.g., expansion of IRAs, Roth IRAs, SIMPLE IRAs).

Finally, the COLI proposal would create a retroactive tax increase on millions of businesses and middle-class working Americans by denying an interest deduction on policies that have been in place for years. Businesses that relied on existing tax laws would be penalized and employees who relied on benefits funded by existing insurance policies would be unconscionably harmed.

Far from the Administration's characterization of COLI as an abusive tax shelter, COLI is an appropriate means to fulfill the American goal of uninterrupted business operation while providing retirement security to employees.

PROPOSAL: MODIFY RULES FOR CAPITALIZING POLICY ACQUISITION COSTS OF LIFE INSURANCE COMPANIES

Background:

In 1990, Congress enacted Section 848, which requires that insurance companies capitalize a portion of policy acquisition costs. This co-called "DAC tax" sought to match the timing of some of the expenses incurred in the sale of insurance products with the income received over the product life.

Effect of Proposal:

This proposal increases the "DAC tax" and thereby increases the cost for life insurance and annuity products to the American public. This added cost reduces the attractiveness and effectiveness of life insurance and annuity policies as long-term financial security vehicles.

The proposal represents an indirect tax on people who seek to provide financial protection for their retirement or their family to meet future unexpected circumstances.

The proposed increase in tax on insurance products will be largely passed on to and borne by the purchasers of those products. The "DAC tax" burden on annuity products would be *tripled* and the tax on life insurance products would be increased by *two-thirds*.

Last year, Treasury tried to impose new direct taxes on insurance product policyholders. Congress rebuffed that attempt. Now Treasury returns and seeks to do indirectly what Congress refused to permit it to do directly.

As the Administration recognizes in its social security proposals, individuals need to ensure that adequate resources are available in retirement. This proposal perversely *discourages* individuals from providing for their retirement by imposing new taxes on their doing so.

Life insurance and annuity products are designed to help provide long-term financial security needs of Americans. It is desirable that these products be available to the public in a predictable and cost efficient manner. Cash value life products efficiently and effectively bundle protection and saving elements into a package that provides early protection against loss and generates long-term earnings that can be used as a source of retirement funds or to offset the higher cost of providing loss protection benefits at older ages. To encourage the long-term nature of these products, current law already taxes gains and imposes penalty taxes where contracts are surrendered without providing the intended death and retirement benefits. This proposal effectively acts as a preemptive tax penalizing all contracts in advance.

The Treasury proposal says that the current "DAC tax" does not provide for capitalization of actual acquisition expenses. But capitalization of acquisition expenses are also currently taken into consideration in the Internal Revenue Code through the computation of tax reserves. This computation requires that first year expenses be spread over future years, which reduces deductible tax reserves in the first policy year and spreads the recognition of these expenses over future policy years.

In any event, the current "DAC tax" was the result of considered Congressional deliberations in 1990 to strike a balance between capitalization policy and the need to avoid imposing unreasonably heavy taxes on the insurance industry. It is inappropriate for Congress now to revisit that decision (particularly in absence of significant change in the underlying facts).

Statement of Management Compensation Group, Portland, Oregon

I. INTRODUCTION

We appreciate the opportunity to submit this written statement for the record of the House Ways and Means Committee hearing on the "Revenue Provisions in the President's Fiscal Year 2000 Budget." We are the Management Compensation Group ("MCG"), a group of independently owned firms located across the country, dedicated to assisting businesses to provide retirement, health and other benefits to their employees. We help small, medium and larger businesses finance benefit plans through the purchase of corporate-owned life insurance ("COLI"). The use of COLI serves a valid social and economic purpose in financing these benefit plans.

The President's FY 2000 Budget reproposes a modification to the COLI rules which was soundly rejected by Congress last year. The President's proposal, which was also contained in his FY 1999 Budget, would apply the proration rule adopted in the Taxpayer Relief Act of 1997 (P.L. 105–34) to virtually all COLI, by eliminating exceptions to the rule for employees, officers and directors (the "COLI proposal"). Without discussion, the COLI proposal is listed in the FY 2000 Budget under the heading of "Corporate Tax Shelters."

As in the testimony we submitted last year, *we again strenuously OBJECT to the President's COLI proposal.*

In this statement, we will provide a description of the President's COLI proposal; background on the legitimate business uses of COLI and the history of tax changes; support for why COLI is not a tax shelter; and a discussion of why the President's COLI proposal should again be rejected outright by Congress.

II. THE PRESIDENT'S COLI PROPOSAL

Under current law, businesses are generally allowed a tax deduction for interest on indebtedness incurred in their trade or business. Businesses often own life insurance policies on the lives of their employees, officers and directors. These policies meet a number of business needs, including: (1) providing financial liquidity; (2) allowing businesses to fund employee and retirement benefits; (3) providing continuation of business operations upon the death of a key executive; and (4) providing survivors with death benefit protections.

The tax laws deny an interest deduction on any indebtedness WITH RESPECT TO life insurance policies. Therefore, any interest which is directly related or "traceable” to a life insurance policy is already denied under current law. If there is no relationship between the indebtedness and a corporate-owned life insurance policy on an employee, officer or director, then there is no denial of interest.

The President’s FY 2000 Budget plan reproposes a modification of the COLI rules which was proposed in his FY 1999 Budget and soundly rejected by Congress last year. The proposal would change the current COLI rules and deny interest deductions on indebtedness incurred by a business completely UNRELATED to the ownership of insurance on an employee, officer or director. This proposal would have a devastating impact on businesses and employees throughout the country.

III. BACKGROUND OF BUSINESS USES OF COLI AND HISTORY OF TAX CHANGES

1) Permanent Life Insurance For Business

The use of permanent life insurance in a business setting first arose as a means to protect against the premature death of key employees. The savings element in permanent life insurance also allowed for the accumulation of value for use in the buyback of stock or to protect against business interruption.

As businesses saw a need to fund for pension and other benefit liabilities that fell outside of their qualified plans, COLI in its current use evolved. The combination of predictable premiums, long-term asset accumulation and protection against death benefit liabilities makes COLI an ideal funding vehicle for these programs.

In these arrangements, businesses purchase COLI in an amount necessary to match the emerging liabilities for benefits outside of qualified plans. The COLI asset is typically placed in a trust, and specific arrangements are made to eliminate excess assets from building up within the trust. While such assets remain available to creditors should bankruptcy occur, they are otherwise pledged and held in trust for the sole purpose of extinguishing corporate liability associated with the benefit plans.

Funds used to purchase COLI are paid with after-tax dollars. The growth of these funds only serves to help the plans keep pace with the emerging liability. If cash value is withdrawn from the policies, it is subject to taxation at ordinary income rates. The company foregoes a current deduction, unlike qualified pension plans, and provides a dedicated buffer for future pension payments. Funding under these plans is typically limited to those eligible for participation in these programs.

2) History Of Tax Changes Related To COLI

In the past, Congress has been concerned about the use of COLI as a pure investment vehicle without appropriate insurance elements. As a consequence, it has acted to restrict COLI and certain investment-oriented insurance products, while protecting the tax-deferred nature of permanent life insurance.

The 1954 Code contained a provision limiting interest deductions on loans taken out directly or otherwise to purchase insurance (Code section 264). Since then, Congress has strengthened this provision several times. Most recently, in the Taxpayer Relief Act of 1997 (the “1997 Act”), Congress eliminated a broad range of exceptions and generally disallowed any interest on indebtedness “with respect to” the ownership of a life insurance contract. This disallowed any direct and “traceable” interest. A limited exception for “key person” policies under $50,000 remained in place.

The 1997 Act also added a new “proration” rule which denied interest deductions on indebtedness “unrelated” to the ownership of insurance policies. An exception to the proration rule was provided for insurance purchased on lives of employees, officers, directors, and 20 percent owners (Code section 264(f)). This exception is the subject of the President’s COLI proposal.[1]

IV. *COLI IS NOT A “TAX SHELTER”*

Without discussion, the COLI proposal is listed in the FY 2000 Budget under the heading of “Corporate Tax Shelters.” COLI is not a “corporate tax shelter.”

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[1] Other changes affecting insurance products occurred over the years. Certain investment-oriented insurance products called “modified endowments” were restricted by Congress in 1988. This class of policies loses many or some of the favorable treatment available to other contracts under Code section 72. Congress in 1990 imposed another limitation on insurance policies with the enactment of the deferred acquisition cost provision (Code section 848)(the “DAC tax”). This provision limits the ability of insurance companies to deduct immediately the costs incurred in issuing a policy. The economic effect of the DAC provision has been to impose a federal premium tax.

In a February 12, 1998 House Ways and Means hearing last year on "Reducing the Tax Burden," Chairman Archer entered into an exchange with Congressman Kucinich on the President's FY 1999 tax proposals which included the same COLI proposal contained in this year's budget plan. The exchange is as follows:

> CHAIR ARCHER: "If the gentleman is referring to the list that the President has se[n]t up [the President's FY 1999 budget revenue raisers, which includes the exact same COLI proposal]
>
> MR.KUCINICH: I am.
>
> CHAIR ARCHER: Then, I would simply tell him, even the Washington Post had an article in the last week with headlines that it "Slams the middle class. It hits widows with annuities, taxes savings which are inside build-ups of life insurance policies, which hits the holders of those policies," and those are the major areas of revenue raising.
>
> If you call those loopholes, I think you're going to find there are an awful lot of people in this country, including widows with annuities, are going to come out and say, "Wait a minute. *That's not a loophole*." (emphasis added) *See,* "Unofficial Transcript of Ways & Means Hearing on Reducing Tax Burden," reprinted in Tax Notes Today (February 18, 1998)

COLI is not a loophole and is not a corporate tax shelter. As discussed above, the use of COLI is well-documented as a legitimate means of funding employee retirement, health and other benefits. While some would argue that Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits and that it was not intended that COLI be used to circumvent statutory limits, these arguments are specious and do not support a determination that COLI is a "tax shelter."

Congress has long been aware of the legitimate use of COLI to fund retiree health benefits and supplemental pension benefits. The tax results achieved through the use of COLI are not "unintended," are not "unwarranted," and do not involve "aggressive interpretations" of the law. The legitimate use of COLI does not involve tax evasion, is not offered under conditions of confidentiality and clearly does not fall within the existing definition of "corporate tax shelter," under section 6111(d) of the Code. By any reasonable standard the use of COLI does not rise to the level of being described as a "corporate tax shelter."

V. *DISCUSSION OF PROPOSAL*

The President's COLI proposal is seriously flawed, inequitable, overly broad, and unjustified. It must again be REJECTED by Congress.

1) "Tax Arbitrage" Is A Smoke-Screen and Ignores Existing Statutory Limitations

While the Administration has in the past suggested that traditional COLI provides unwarranted tax arbitrage, the argument is not persuasive and is nothing but a smoke screen to mask its attempt to tax inside build up of life insurance—a proposal that likewise has been resoundingly rejected in the past.

There are legitimate tax policy reasons for allowing ordinary and necessary tax deductions for businesses that incur indebtedness and pay interest expenses. Similarly, there is a valid tax policy reason for allowing businesses to own permanent life insurance and for allowing the growth of these policies to be tax-deferred.

To arbitrarily tie these two fundamental tax concepts together as a means of raising revenue is disingenuous. If denying a deduction for an expense completely unrelated to an item of income were acceptable, we would have complete chaos in the tax code.

An example of how ill-conceived this policy would be is the case of a taxpayer who earns tax-deferred income in a ROTH IRA and also makes tax deductible mortgage interest payments. If the taxpayer's mortgage interest deduction were denied on the theory that he/she has "tax arbitrage" from unrelated tax-deferred earnings in the ROTH IRA, the entire tax code would have to be reviewed and the deductibility of deductions would always be in question. The purpose of the tax deferral, in this case to increase the ability of Americans to save for retirement and the interest deduction, to promote home ownership, are completely unrelated. There is no connection between the ROTH IRA and the mortgage indebtedness just as there is no connection here between the business indebtedness and the COLI policy. In the business setting, the analogy would be to deny an interest deduction on the purchase of office equipment solely because a business purchased key man life insurance.

Importantly, current law contains safeguards for interest that is "related" or "traceable" to the ownership of life insurance, denying interest deductions in such cases. These safeguards came about through major reforms by Congress over the past 20 years to the taxation of life insurance. Starting in the early 1960s and continuing through the mid–1990s, these changes to the Internal Revenue Code address perceived problems and prevent abusive leveraging of life insurance. As described above, the most recent changes occurred in the 1997 Act.

The President's COLI proposal ignores this history and statutory safeguards, and goes well beyond the established criteria approved by Congress and the Administration. Rather than looking at whether there are specific relationships between the policy and the indebtedness or the policy and other criteria deemed to be "investment oriented," the President's COLI proposal attempts to disallow deductions for completely unrelated interest. The Administration apparently believes that allowing a taxpayer a deduction for interest incurred on indebtedness in the operation of a business is wrong if the business owns life insurance on its employees, officers, or directors, even if the business indebtedness is completely unrelated to the insurance. This belief is contrary to fundamental principals of tax policy as well as the social objectives such deductions are meant to achieve.

2) The COLI Proposal is Inequitable

By denying interest deductions on businesses that own life insurance, the President's COLI proposal creates unjustified inequities between businesses that rely on debt financing and those that are equity-financed. Under the proposal, two taxpayers in the same industry would be treated differently for tax purposes depending on whether they incurred debt in the operation of their business or whether they relied on equity investments.

In addition, businesses in different industries would be treated differently as a result of the proposal. Many capital intensive industries rely heavily on debt and would be disproportionately disadvantaged because the proposal would deny their interest deductions. This would occur even though the debt-financed businesses would own the same amount of life insurance and provide the same amount of employee and retirement benefits as their equity-financed competitors.

3) Back Door Tax Increase on Cash Value and Unrealized Appreciation in Business Assets

Like the proposal which was rejected last year, the President's FY 2000 budget proposal would apply the 1997 proration rules to all COLI and BOLI. Effectively, this would result in a backdoor taxation of cash values on all business life insurance.

As stated above, permanent life insurance has traditionally been a tax-favored investment for good social and tax policy reasons. The essential element of the insurance—to protect against the premature death of a key employee—and the use of the "cash value" savings element—to protect against business interruption or to fund pension and retirement benefits—have long been recognized as worthy goals.

By denying an interest deduction to businesses that own such policies and tying the denial to the "pro-rated" amount of "unborrowed cash value," the Administration is indirectly "taxing" the cash value on permanent insurance owned by a taxpayer. Traditional concepts of fairness should prevent the Administration to do indirectly what they choose not to do directly.

Moreover, this indirect tax increase on the cash value of a life insurance policy results in a tax on the "unrealized appreciation" in a taxpayer's asset. This result would be similar to taxing a homeowner each year on the appreciation of his/her home.

Fundamental concepts of tax policy dictate that taxes generally should be incurred on the "recognition" of a taxable event, such as a sale or exchange of property. To now impose a tax on "unrealized appreciation" would not only violate traditional concepts of tax policy, but could result in huge administrative burdens on taxpayers and the government if followed in other areas of the law.

Finally, it should be recognized that the cash value of life insurance is incidental to the underlying purpose of a "permanent life insurance" policy. The fundamental nature of the policy is the protection of risk of death. Cash value is merely an incident of this purpose. Legally, cash value is reserved to pay death benefits and is provided to policyholders through Non-Forfeiture provisions mandated under State law.

4) Unjustified Elimination of Funding for Employee and Retirement Benefits

The President's COLI proposal would increase current taxes on all businesses that own or are the beneficiaries of a permanent life insurance policy. It would seriously curtail the availability of the benefits these policies fund and increase the risk of business failure from loss of a key employee. While there is a clear relationship between the providing of insurance and the funding of benefits, there is no relationship between interest on business indebtedness and unrelated insurance used to fund benefits.

Current rules already limit potential abuses in traditional COLI applications. Code section 264 prevents leveraged arbitrage from tax-deductible borrowing "related to" a corporate-owned life insurance policy. Code section 7702 and 7702A require corporate-owned policies to provide a reasonable amount of death benefit protection. And qualified plan limits restrict the amount of insurance that can be purchased by an employer on a currently deductible basis. It is not clear what public purpose extending these rules to cover unrelated interest deductions would serve.

The effect of the President's COLI proposal would be to limit wholly appropriate business uses of life insurance by making the cost of insurance products economically infeasible. Eliminating business owned life insurance could result in the elimination or reduction in the amount of employer-provided employee and retirement benefits. Such a change would put unnecessary and undue pressure on Social Security and public financing of benefits. At a time when the country faces significant funding problems with Social Security, there is no sound policy reason to put additional burdens on financing of employee benefits and retirement savings.

In attempting to correct perceived abuses of COLI, the proposal unnecessarily deprives businesses of the legitimate benefits of COLI to protect against business interruption, loss of a key employee, or to fund employee benefits. The COLI proposal is overly broad and imposes restrictions far beyond those needed to address any perceived abuse. If there are abuses to be corrected, they should be addressed in a more narrow manner.

5) COLI Proposal is Inconsistent with Well-founded Savings and Retirement Policies

At the very same time that the President and Congress are calling for more tax incentives for personal savings and directing attention to the impending retirement security crisis, the President is proposing a provision that would ultimately reduce personal savings.

The President and Congress have repeatedly called for new long-term savings provisions (*e.g.,* Universal Savings Accounts (USAs), ROTH 401(k)s) and expansions of existing savings provisions (*e.g.,* increases in traditional IRA limits, Roth IRAs limits, and 401(k) limits). By indirectly "taxing" life insurance which funds retirement and benefit programs, the COLI proposal moves in the complete opposite direction of such efforts. By undermining these initiatives, the COLI proposal stands out as a stark example of inconsistent and contradictory tax and retirement policy.

Moreover, the President's COLI proposal will harm retirement savings initiatives and have an overall negative impact on the National savings rate in the United States.

VI. CONCLUSION

Like last year, we urge the Committee to again reject in its entirety the President's COLI proposal. The proposal is seriously flawed, inequitable, overly broad, and unjustified. It negatively impacts life insurance policyholders and the entire insurance industry, including insurance companies and agents across the United States. Moreover, it goes well beyond any perceived abuses raised by the Administration. *It was rejected by Congress last year and should be rejected again.*

We would be happy to provide the Committee with additional information about the legitimate business uses of life insurance at any time.

Statement of the Massachusetts Mutual Life Insurance Company

Massachusetts Mutual Life Insurance Company is the eleventh largest life insurance company in the United States, doing business throughout the nation. The Company offers life and disability insurance, deferred and immediate annuities, and pension employee benefits. Through its affiliates, Massachusetts Mutual offers mutual funds and investment services. The Company serves more than two million policyholders nationwide and, with its affiliates, has more than $175 billion in assets under management. Massachusetts Mutual is deeply concerned about the Administration's renewed attack on cash value life insurance and annuities. The Administration would seriously impair the ability of families and businesses to make reasonable provisions for retirement and survivor needs. We appreciate the opportunity to offer testimony concerning the Administration's proposals.

BUSINESS OWNED LIFE INSURANCE

The Administration has renewed its proposal to penalize businesses that hold cash value life insurance, a proposal that Congress rejected last year after extensive review. This year, the Administration has tried to categorize business life insurance as a tax shelter that provides unwarranted benefits to business entities. However, in the Administration's own terms, the definition of a tax shelter does not include any "tax benefit clearly contemplated by the applicable provision" of current tax law. Over the past few years, Congress has repeatedly examined the tax treatment of business life insurance. The current rules are a direct product of that analysis. Congress clearly considered the tax benefits for business life insurance when it passed the recent amendments to the applicable provisions of the Internal Revenue Code. In reality, the Administration proposal is an attack on the inside build-up of policy values.

Congress has already eliminated the use of life insurance for tax arbitrage. Congress has created appropriate and effective limitations on the ability of a business entity to deduct interest on debt when it holds cash value life insurance. Following amendments enacted in 1996, federal law allows a business to take an interest deduction for loans against only those insurance policies covering the life of either a 20% owner of the business or another key person. No more than 20 individuals may qualify as key persons and the business can deduct interest on no more than $50,000 of policy debt per insured life. A special rule grandfathers policies issued before June 21, 1986. The 1997 tax act then limited the interest a business can deduct on its general debt if the business also has cash value life insurance on a person other than its employee, officer, director or 20% owner (or a 20% owner and spouse). To determine its allowable interest deductions, a business must reduce its general debt proportionately to take into consideration the unborrowed cash values in policies it holds on insureds not covered by these exceptions. This "pro rata" disallowance rule applies to policies issued or materially changed after June 8, 1997.

The President's budget proposals would destroy the carefully crafted limitations set by the 1996 and 1997 amendments to the Internal Revenue Code. The Administration would extend the pro rata disallowance rule to all business owned life insurance policies except those covering 20% owners. Although the Treasury Report and the Joint Committee explanation are ambiguous on the subject, the report issued by the OMB indicates that the Administration would also eliminate the interest deduction for loans against any policies other than those insuring 20% owners of the business. In addition, the Administration would not grandfather policies that were purchased under prior laws.

The proposals would make cash value life insurance prohibitively expensive for all businesses. By excepting only policies that insure 20% owners, the Administration ignores the fact that business life insurance serves many legitimate, non-tax purposes. Certainly, life insurance provides a means for businesses to survive the death of an owner, offering immediate liquidity for day-to-day maintenance of the business or the funds to purchase the decedent's interest from heirs who are unwilling or incapable of continuing the business. The Administration has declared that an exception for policies insuring 20% owners would adequately protect the legitimate business use of cash value life insurance. Nevertheless, despite the Administration's unsupported assertions, the purchase of life insurance to fund business buy-outs is not the sole legitimate use of business insurance. Businesses employ life insurance for many other equally meritorious purposes.

A business must protect itself from the economic drain and instability caused by the loss of any major asset. More than any machinery, realty or tangible goods, the talents of its key personnel sustain a business as a viable force in the economy. Life insurance provides businesses with the means to protect the workplace by replacing revenues lost on the death of a key person and by offsetting the costs of finding and training a suitable successor. Businesses use life insurance to provide survivor and post-retirement benefits to their employees, officers and directors. As part of a supplemental compensation package, these benefits help attract and retain talented and loyal personnel, the very individuals who are crucial to the ongoing success of any business. The Administration proposal would significantly increase the cost for a business to protect itself or to provide benefits. In fact, the Administration would penalize businesses for providing even a split-dollar life insurance plan to assist employees in providing for the security of their families.

In 1996, Congress revised the rules for deducting interest on policy loans to impose limits on the number of insureds and the amount of policy debt. Businesses need to retain the ability to borrow against policies on their key persons without incurring a tax penalty. Buying key person insurance makes sound business sense, but it requires a long-term commitment of capital. The business policyholder must have the flexibility to borrow against such policies in times of need without adverse tax consequences. The current key person exception is especially important to smaller businesses that have less access to alternative sources of borrowing. The rules enacted in 1996 have successfully curtailed the abusive sale of life insurance for tax leverage.

Two years ago, Congress examined the tax treatment of general debt where a business also happened to hold cash value life insurance. Based on this review, it created a tax penalty for businesses that hold life insurance on their debtors, customers or any insureds other than their employees, officers, directors or 20% owners. Last year, as part of its fiscal year 1999 budget, the Administration proposed extending the penalty to all business life insurance policies other than those covering 20% owners. Congress re-examined the treatment of unrelated business debt and rejected the Administration's proposal last year. Now, the Administration has submitted the same proposal, with no better tax policy justification than it has offered in the past.

The legitimate needs for workplace protection insurance have not altered in the past three years. Nor will the business need for life insurance simply disappear if the pro rata disallowance rule is extended to policies covering employees, officers and directors. However, the resulting cost for businesses will increase if they cannot deduct interest on their general debt because they also hold cash value life insurance. The pro rata rule disallows that part of a business' interest deduction which is in the same proportion to its total interest deduction as the unborrowed cash values of policies it holds are to its total assets. As a result, the Administration proposal would most seriously hurt smaller businesses with higher debt to asset ratios and service companies that hold fewer assets but depend on their personnel for their economic well being. In effect, these businesses which rely more heavily on the contributions and talents of their workforce will incur a heavier financial burden if they try to insure against the risk of losing key personnel or if they try to provide employee benefits. Term insurance does not provide businesses with a reasonable alternative to cash value insurance. While often appropriate for temporary arrangements, term insurance is both costly and unsuitable for long-range needs. The loss of interest deductions on unrelated borrowing is an exceedingly harsh punishment to impose on a business for taking prudent financial measures to protect its valuable human assets or to provide benefits for its employees and retirees.

Congress has repeatedly examined the tax treatment of business owned life insurance. Amendments it has passed in the last several years have effectively curtailed the use of life insurance for tax arbitrage. There is no reason to change the rules yet again. There is no justification for the Administration's proposal to penalize businesses that purchase cash value life insurance to safeguard their own well being or to provide benefits for their workforce. Businesses use life insurance for legitimate purposes. Like any other taxpayer, a business also needs some stability in the tax law in order to make long-term plans for its own financial welfare and that of its employees. The Administration would have Congress revisit the tax treatment of business life insurance, for the fourth time in four years, with the express purpose of removing the carefully crafted rules set in the 1996 and 1997 tax acts.

MULTIPLE-EMPLOYER WELFARE BENEFIT PLANS

Internal Revenue Code Section 419A prescribes the requirements under which an employer can deduct contributions to a multiple-employer plan that provides certain welfare benefits for participating employees. For any employer to secure the deduction, the plan must involve ten or more employers and must meet certain other restrictions. Among other permissible benefits, multiple-employer plans can provide death benefits for covered employees. The Administration proposes to ban the use of cash value life insurance to provide death benefits under multiple-employer welfare plans.

Essentially, this proposal is nothing more than another attack on the business use of cash value life insurance. The Administration has declared that term insurance would provide adequately for the promised employee benefits. Notwithstanding the Administration's assertions, it is a basic fact that term insurance becomes expensive for long-range needs and for older employees. A business that participates in a multiple-employer plan might prefer term insurance for younger or more mobile employees and permanent insurance for the more mature employees who are expected to remain with the employer. The use of permanent insurance allows the plan to lock in more favorable insurance rates for the latter category of employees. The flexibility to use either term or cash value insurance allows businesses to make appropriate provisions for their various employees. Permanent policies also create a pool of values the plan trustee can access for premium payments when current year contributions to the plan are inadequate to sustain existing levels of coverage.

All assets in a multiple-employer plan must be applied for the benefit of the participating employees. The employers have no right or access to the plan assets. In fact, the existing law imposes a 100% excise tax on any asset or funds reverting to an employer. Therefore, the already specious arguments against a business holding cash value life insurance have no merit when applied to policies in a multiple-employer welfare benefit plan. The business gets no tax shelter for the growth in policy values and cannot leverage the policies' inside build-up either directly or indirectly. Since the insurance must benefit the participating employees, it clearly does not fit within the Administration's characterization of a corporate tax shelter.

Welfare benefit plans covered under Section 419A cannot provide any form of deferred compensation, experience rating or segregation of plan assets by individual employers. The Internal Revenue Service currently has the authority to regulate welfare benefit plans in order to deny employers any tax deduction for contributions to abusive arrangements. That abuses exist with welfare benefit plans is a fact, as illustrated in several recent court cases. That the Service has not exercised its regulatory authority is, however, another fact. The solution to any abuses is not for Congress to legislate against the use of a particular form of life insurance but for the Service to establish clear guidelines for multiple employer plans.

DAC TAX

In 1990, Congress passed Internal revenue Code Section 848, requiring insurers to capitalize and amortize the acquisition costs arising from the sale of certain non-pension life insurance, annuity and other insurance products. Rather than identify actual acquisition costs, Section 848 employs a proxy method to determine the portion of otherwise deductible life company expenses an insurer must capitalize. Known as the "DAC" tax (for deferred acquisition costs), the proxy method uses as its base set percentages of the premium collected for different types of contracts. The rate for annuities is 1.75% of premium and, for individual life insurance, the rate is 7.70%. To compute the amount of general deductions that it must capitalize rather than deduct currently, an insurance company would then total the relevant percentages of the premiums it received. Capitalized amounts are generally amortized over 10 years, using a half year convention: i.e., of the amount capitalized, the insurer would deduct 5% in the year of capitalization, 10% in each of the next 9 years, and 5% in the following year. Small insurers get a corresponding 5-year amortization.

The Clinton Administration proposes significant increases to the DAC rates for annuities and cash value life insurance. The annuity rate would rise to 4.25% for the first five years, and to 5.15% thereafter. For permanent life insurance, the rate would jump to 10.50% for the first five years and to 12.85% thereafter. These proposed increases are draconian and would significantly impede the ability of insurers to compete in the financial market. Moreover, the owners of annuities and cash value life insurance policies would ultimately bear the burden of the higher DAC rates. The steep rise in the DAC rates would inevitably increase the cost for policyholders who use life insurance as a safety net or annuities as a safeguard against outliving their assets. The Administration proposal, which would increase the cost for policyholders to provide for their retirement and survivor needs, is inconsistent with its stated goal of encouraging taxpayers to take responsibility for their financial well being.

When enacted, the DAC tax imposed a major tax increase on the life insurance industry, raising by approximately 50% the aggregate tax paid by the industry at the time. The 5-year revenue estimate was $8 billion, while the industry tax bill at the time ranged from $3 to $3.5 billion per year. The Administration's current proposal would turn an already significant tax into a punitive economic burden.

The DAC provision represents a very arbitrary and costly addition to the tax burden on the life insurance industry and its customers. Despite its name and stated intent, the DAC tax focuses not on company acquisition expenses but rather on gross premium receipts. The fact that an insurer's successful efforts to control or reduce expenses have no effect on its DAC capitalization highlights the arbitrary nature of the tax. The proxy bears no relation to the company's actual acquisition costs, particularly in the current financial environment when costs are dropping significantly throughout the industry. Purportedly targeting acquisition costs, section 848, in reality, taxes gross revenue. With a base of total premium rather than first year premium, the DAC tax is not related to acquisition costs.

Moreover, the DAC provision ignores the fact that the federal tax system already imposes a proxy capitalization requirement. Insurers must also reduce their reserve deductions by a formula that effectively amortized policy acquisition costs. In effect, insurers suffer a double hit. They must use a lower reserve deduction to take into account acquisition costs and they must also defer deductions for deemed "acquisition" costs.

Increased taxes on the premiums insurers receive will raise the price of insurance products and make it more difficult for consumers to protect their survivors and provide for retirement needs. In pricing life insurance, a common industry practice is to charge for DAC as if it were another premium tax, but in the 1–1‡ % range, a method that reflects the DAC cost to the insurer. This one component of the federal income tax ultimately costs policyholders more than half of the total state tax imposed on life insurance. The Administration proposal would increase this cost to more than the total state tax cost. When Congress is looking for ways to encourage personal savings, it makes no sense to increase taxes on annuities and life insurance, products designed specifically for long-term financial planning.

The Administration would justify the significant increase in the DAC rates as a means to guarantee that life insurers pay their fair share of federal income taxes. Contrary to widespread misperception, the life insurance industry is already a substantial federal taxpayer. As measured by a Coopers & Lybrand study done for the American Council of Life Insurance, the average effective tax rate for U.S. life insurers was 31.9% over the 10-year period of 1986–1995. The effective tax rate for all U.S. corporations for that same period was only 25.3%. In fact, the Coopers & Lybrand study reveals that life insurers' effective tax rate rose from 23.9% in the 1986–1990 period to 37.1% for the period 1991 through 1995. The hefty increase in the effective tax rate resulted primarily from the enactment of the DAC provision. The current DAC tax on premiums hurts the life insurance industry in competing with other financial intermediaries for savings dollars. Surely, no increase in this tax is warranted.

Conclusion

The revenue provisions contained in the President Clinton's budget for fiscal year 2000 would drastically increase the tax burden on life insurers and their policyholders. The Administration would penalize businesses for using cash value life insurance to provide for their own financial protection and to extend benefits for their workforce. Congress has recognized the legitimate business use of permanent life insurance and, in the past few years, crafted a careful set of rules to eliminate the potential use of insurance as a tax arbitrage. The Administration would now overturn all those rules it so recently signed into law, not because of any discernible abuse but because it deems the purchase of cash value life insurance to be an inappropriate use of business funds. The proposed ban on cash value life insurance in multiple employer plans would deprive a business of the discretion to determine the most reasonable funding for its long-term employee benefits. Finally, the proposed changes in DAC rates would increase the tax burden on an industry that is already heavily taxed, diminish that industry's competitiveness in the financial market, and raise the consumer cost of products best suited to encourage savings and responsible planning for inevitable future needs. With projected budget surpluses, it is inconceivable that the Administration would seek to raise substantial taxes from an industry uniquely qualified to help families and businesses provide for their financial security.

Statement of Hon. Jim McCrery, a Representative in Congress from the State of Louisiana

Mr. Chairman, as you know, thirty-one members of this Committee signed a letter to you and Mr. Rangel opposing the insurance proposals in the FY 2000 budget. Some of these tax increases, such as the COLI proposal, were rejected by Congress when they were part of the President's budget last year. The new provisions, such as the DAC tax proposal, similarly represent tax increases on products that help enhance American's retirement security and their ability to protect their families and businesses. Mr. Chairman, I would like to reiterate my strong opposition to these tax increases.

Congress of the United States
Washington, DC 20515

February 4, 1999

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles Rangel
Ranking Member
Committee on Ways and Means
2354 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Archer and Ranking Member Rangel:

We are concerned about the tax increase proposals included in the President's budget which are aimed at life insurance and annuities. Americans are taking more responsibility for their own long-term financial security, and they have made it clear they oppose both direct and indirect tax increases on products that help enhance their retirement security and their ability to protect their families and businesses.

Last year, under your leadership, our committee rejected an $8 billion package of insurance tax increases with a strong bipartisan majority firmly on record in opposition to them. We encourage you again to oppose the enactment of the Administration's tax proposals this year which would increase the cost of providing long-term financial security and protecting the future well-being of all Americans.

Especially now, during a time when Congress and the Administration are exploring new ways to help and encourage our constituents to prepare for their retirement years, these kinds of tax increases only serve to make planning and providing for retirement more expensive and more difficult.

As we work together in the coming months for bipartisan solutions to our country's problems, we believe it would be ill-advised and counter-productive for Congress to advance these unwarranted proposals. Once again, we urge you to reject them.

Dave Camp

Jennifer Dunn

John Lewis

Mark Foley

Phil English

Robert T. Matsui

Rob Portman

Ron Lewis

Sander Levin

Jerry Kleczka

Sam Johnson

Michael R. McNulty

Jim Ramstad

J.D. Hayworth

Ben Cardin

Amo Houghton

Jim Nussle

Phil Crane

Wally Herger

Karen L. Thurman

Jim McDermott

Clay Shaw

Statement of Mechanical-Electrical-Sheet Metal Alliance

The Mechanical—Electrical—Sheet Metal Alliance (the Alliance) vigorously urges members of the House Ways and Means Committee to reject a provision in the Administration budget proposal that would levy an income tax on association investment income. This proposed tax would compromise the beneficial public and economic interest programs carried out by tax-exempt business associations.

The Mechanical—Electrical—Sheet Metal Alliance represents more than 12,000 specialty construction contractor members of the Mechanical Contractors Association of America (MCAA), the National Electrical Contractors Association (NECA) and the Sheet Metal and Air Conditioning Contractors National Association (SMACNA). Alliance contractors employ over half a million highly skilled construction trades workers.

The proposal would tax association investment income over $10,000. This taxable income would include dividends, interest, royalties, rents, and certain gains and losses from dispositions of property described in IRC section 512(b)(5) (i.e., capital gains). Associations keep reserves that earn income to protect against shortfalls in dues from year to year. While reserves typically are limited, income on those amounts should remain dedicated to the association's tax-exempt purposes.

An income tax of this nature would have a negative impact on the privately funded career training and safety services provided to Alliance member companies. Not only would this tax affect the three Alliance national associations, but in addition would affect each of their combined 292 affiliated state and local chapters independently.

SAFETY AND HEALTH PROGRAMS

The Alliance prides itself on the safety and health programs that it makes available to its members. MCAA received the Construction Industry Safety Excellence Association Development Award Grant in 1997. Additionally, NECA and SMACNA received the prestigious Business Roundtable (BRT) Construction Industry Safety Excellence (CISE) Association Excellence Award in 1998 and 1997, respectively. According to the BRT CISE Awards Committee, this award marks outstanding "leadership in improving construction site safety, demonstrated through strong programs and effective measurement systems that collect and distribute safety performance data for members' guidance." BRT is an organization of more than 200 chief executive officers from leading U.S. corporations.

Each year, the Alliance hosts a conference for industry safety professionals. The Construction Alliance Conference on Risk Management and Safety, offers workshops on establishing effective safety management programs, complying with workers' compensation statutes and provides updates on current Occupational Safety and Health Administration initiatives. Construction industry injury rates are declining nationwide because of these efforts.

CAREER ADVANCEMENT AND MANAGEMENT TRAINING

Alliance member organizations offer a vast array of career enhancing services for all industry employees—from production craft through supervisory, professional and administrative employees. The three Alliance associations host national conventions with industry-related education as the primary focus. Each individual association also provides professional programs designed for chapter association managers.

MCAA conducts its Institute for Project Management (IPM), a two-week curriculum that presents systematic strategies for improving job site management. This continuing education certified program has been held twice a year for the past twelve years. MCAA also conducts its Mid-Year Education Conference, where project managers from member companies learn about construction claims, managing multiple projects, estimating, coping with substance abuse, people management, and leadership skills.

In 1998 SMACNA produced 32 Technical Manuals, provided material and personnel for 35 Technical seminars, and has a growing Technical University Program all designed for contractors, engineers and design professionals. In addition, SMACNA sponsors wide-ranging educational programs for the future contractor leaders in the sheet metal and air conditioning industry including a Business Management University Program, a Graduate Business Management Program, a Supervisory TrainingProgram, and hosts of other educational seminars—57 in 1998.

In 1998, NECA introduced its Management Education Institute (MEI). MEI conducts seminars in 12–14 cities per year, covering topics such as company management, field supervision, project management, estimating, marketing, safety and insurance and more. MEI also includes a virtual campus, which is open to everyone, on topics such as financial accounting and effective leadership to name a few.

CODES AND STANDARDS

To a much greater extent than other countries, U.S. commerce and industry depends on a so-called voluntary standards system for regulation of health, safety, performance, and ratings of products and systems. These voluntary standards are written by private sector organizations including trade associations and professional societies, and ratified by an open consensus process administered by the American National Standards Institute (ANSI).

The U.S. government has recognized the importance of this voluntary standards system for meeting federal procurement and safety goals through Office of Management and Budget Circular A–119 and the 1996 Technology Transfer Act. Both of these encourage government agencies to depend on private standards setting to the extent feasible and give guidance for agency participation in the voluntary standards system. Federal participation is coordinated by the National Institute of Standards Technology (NIST), working in close coordination with ANSI. Alliance associtions' active involvement in creating and implementing model codes would be limited if new association taxes were levied.

The National Certified Pipe Welding Bureau (NCPWB), a department of the MCAA, helps create uniform welding procedures that adhere to nation-wide welding codes. These uniform procedures help MCAA members to furnish safe and dependable pipe installation, and uniformly trained and qualified welders, that ensures public safety.

SMACNA develops technical standards, manuals, and guidelines for the construction industry addressing all facets of sheet metal and HVAC fabrication, manufacturing, and installation. SMACNA produces almost twice as many technical standards and manuals as it did ten years ago.

NECA is an active participant in the development of the National Electrical Code (U.S. national wiring rules) and 23 other voluntary electrical and safety standards written by private-sector organizations. NECA is also the developer and publisher of a series of construction quality documents called the National Electrical Safety Standards.

State and Local Associations

Each of the Alliance members' affiliated associations (chapters) also conduct many more parallel programs in their areas to advance the industry and high-skilled workforce standards and careers in those communities. Alliance affiliates sponsor journeyman upgrade training, career advancement training, safety and skills certification. In addition, many chapters engage in community service as well, working with Habitat for Humanity and senior citizen HEATS-ON programs in many areas. All these programs are funded from association revenues—and in lean years in a very cyclical industry—from association reserve funds and income earned on them. These contingency-funding sources must be preserved.

The Alliance would like to thank the Committee on Ways and Means for the opportunity to submit comments on this issue. Again, Alliance member programs as outlined in this statement, and countless others including charitable work done by both the national associations and local chapters, would be put at great risk if the Administration proposal were to become law.

Statement of Merrill Lynch & Co., Inc.

Merrill Lynch is pleased to provide this written statement for the record of the March 10, 1999 hearing of the Committee on Ways & Means on "Revenue Provisions in the President's Fiscal Year 2000 Budget." [1]

I. *INTRODUCTION*

Merrill Lynch believes that a strong, healthy economy will provide for increases in the standard of living that will benefit all Americans as we enter the challenges of the 21st Century. Investments in our nations future through capital formation will increase productivity enabling the economy to grow at a healthy rate. Merrill Lynch is, therefore, extremely supportive of fiscal policies that raise the United States savings and investment rates. For this reason, Merrill Lynch has been a strong and vocal advocate of policies aimed to balance the federal budget. Merrill Lynch applauds the efforts of this Congress to finally reach the commendable goal of balancing the budget.

While Merrill Lynch applauds the efforts of many to balance the federal budget, it is unfortunate that some of the tax changes proposed by the Administration in its FY 2000 Budget would raise the costs of capital and discourage capital investment—policies contradictory to the objective of a balanced budget. The Administration's FY 2000 Budget contains a number of revenue-raising proposals that would raise the cost of financing new investments in plant, equipment, research, and other job-creating assets. This will have an adverse effect on the economy.

Moreover, many of these proposals have previously been fully considered and rejected out-of-hand by Congress. On many prior occasions, Merrill Lynch has spoken out against the negative impact such proposals would have on our Nation.

[1] Merrill Lynch also endorses the comments submitted to the Committee on these provisions by the Securities Industry Association and The Bond Market Association.

Merrill Lynch agrees with comments by Chairman Bill Archer in announcing these hearings, where he stated:

> "At a time when the Federal Government is collecting more taxes than it needs, the President should not be asking the Congress to adopt proposals that would further increase the tax burden on the American people."

These remarks are consistent with Chairman Archer's prior statement to President Clinton when many of these same proposals were being considered for inclusion in prior budgets. On a broad basis, Chairman Archer stated that he is "deeply troubled and believe(s) that the impact of your plan is fundamentally anti-business, anti-growth and . . . further concerned that the manner in which you have arrived at these proposals appears to be based on how much revenue you can raise from tax increases rather than how to improve the current tax code based on sound policy changes." See, Letter from Chairman Bill Archer to President Clinton (dated December 11, 1995). Chairman Archer also stated that:

> "you have proposed numerous new tax increases on business which reflect anti-business bias that I fear will diminish capital formation, economic growth, and job creation. For example, I don't understand why you would want to exacerbate the current problem of multiple taxation of corporate income by reducing the intercorporate dividends received deduction and denying legitimate business interest deductions. . . . it will not only be America's businesses that pay the tab; hard-working, middle income Americans whose nest-eggs are invested in the stock market will pay for these tax hikes."

Based on these and other serious concerns by Congress, many of the capital market proposals which the Administration is now reproposing were rejected outright in prior years. We see no legitimate reason to now reconsider these unsound policies.

The U.S. enjoys the world's broadest and most dynamic capital markets. These markets allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our preeminent capital markets have long created a competitive advantage for the United States, helping our nation play its leading role in the global economy. Consistent with Chairman Archer's statements, in a period of record budget surplus, the last thing Congress should be considering are more taxes on the capital markets.

Merrill Lynch remains seriously concerned about the damage the Administration's proposals could cause to the capital-raising activities of American business and the investments these companies are making for future growth. Merrill Lynch believes these proposals are anti-investment and anti-capital formation. If enacted, they would increase the cost of capital for American companies, thereby harming investment activities and job growth.

Unfortunately, the Administration's proposals would serve to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. Merrill Lynch believes this move by the Administration to curtail the creation of new financial options runs directly counter to the long-run interests of our economy and our country.

Moreover, there is no policy consistency to many of the Administration's proposals. In many cases, they are a "one-way" street which results in a "heads I win, tails you lose" type standard. By creating anti-taxpayer results on one-side of a transaction, without applying the same rules to the other side of the transaction, the Administration creates further inequities in the Code and erodes voluntary compliance with the tax system.

While Merrill Lynch is opposed to all such proposals in the Administration's FY 2000 Budget,[2] our comments in this written statement will be limited to the proposals that:

- Defer original issue discount deduction on convertible debt. This proposal would place additional restrictions on the use of hybrid preferred instruments and convertible original issue discount ("OID") bonds and would defer the deduction for OID and interest on convertible debt until payment in cash (conversion into the stock of the issuer or a related party would not be treated as a "payment" of accrued OID). This proposal is nearly identical to ones proposed by the Administration in

[2] Other anti-business, anti-growth proposals include the generic "corporate tax shelter" proposals, the proposal to modify the rules for debt-financed portfolio stock, the proposal to require accrual of the time value element on forward sale of corporate stock and the proposal to increase the proration percentage for property & casualty (P&C) insurance companies. There is no inference of support for proposals not mentioned in this written statement.

its FY '97, FY '98, and FY '99 budget plans, which were repeatedly rejected by Congress.

• Eliminate the dividends-received deduction ("DRD") for certain preferred stock. This proposal would deny the 70- and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate, commodity price or similar benchmark. This proposal is also nearly identical to ones proposed in previous budgets, which were also repeatedly rejected by Congress.

Hereinafter these proposals will be referred to as the "Administration's proposals."

To be clear, these proposals are *not* "loopholes" or "corporate tax shelters." They are fundamental changes in the tax law that will increase taxes on savings and investment. They do little more than penalize middle-class Americans who try to save through their retirement plans and mutual funds. Rather than being a hit to Wall Street, as some claim, these proposals are a tax on Main Street—a tax on those who use capital to create jobs all across America and on millions of middle-class individual savers and investors.

It is unfortunate that the Treasury has chosen to characterize these proposals as "unwarranted corporate tax subsidies" and "tax loopholes." The fact is, the existing tax debt/equity rules in issue here have been carefully reviewed—some for decades—by Treasury and Internal Revenue Service ("IRS") officials, and have been deemed to be sound tax policy by the courts. Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are—nothing more than tax increases on Americans.

Merrill Lynch believes that these proposals are ill-advised, for four primary reasons:

• *They Will Increase The Cost of Capital, Undermining Savings, Investments, and Economic Growth*. While Treasury officials have stated their tax proposals will primarily affect the financial sector, this is simply not so. In reality, the burden will fall on issuers of, and investors in, these securities—that is, American businesses and individuals. Without any persuasive policy justification, the Administration's proposals would force companies to abandon efficient and cost-effective means of financing now available and turn to higher-cost alternatives, and thus, limit productive investment. Efficient markets and productive investment are cornerstones to economic growth.

• *They Violate Established Tax Policy Rules*. These proposals are nothing more than ad hoc tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of debt instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

• *They Will Disrupt Capital Markets. Arbitrary and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals have already caused significant disruption in capital-raising activities, as companies reevaluate their options.*

• *They Will Fail to Generate Promised Revenue*. The Administration's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

At a time when the budget is balanced and the private sector and the federal government should join to pursue ways to strength the U.S. economy, the Administration has proposed tax law changes that would weaken the economy by disrupting capital-raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, Merrill Lynch would be delighted to participate in full and open discussions on the Administration's proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to three of the Administration's proposals that would directly affect capital-raising and investment activities in the U.S.

II. *PROPOSAL TO DEFER OID DEDUCTION ON CONVERTIBLE DEBT*

The Administration's FY 2000 Budget contains proposals that would defer the deduction for original issue discount ("OID") until payment and deny an interest deduction if the instrument is converted to the stock of the issuer or a related party. These proposed changes to fundamental tax policy rules relating to debt and equity come under two separate (but related) proposals. Similar proposals were proposed and rejected by Congress a number of times in the past three years.

One proposal, among other things, defers OID on convertible debt. The only stated "Reasons for Change" relating specifically to this proposal is contained in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (February 1999) (the "Green Book"):

> "In many cases, the issuance of convertible debt with OID *is viewed by market participants as a de facto purchase of equity*. Allowing issuers to deduct accrued interest and OID is inconsistent with this market view."

This is the same justification used in Treasury's 1997 and 1998 Green Book and rejected by Congress.

Merrill Lynch strongly opposes the Administration's proposal to defer deductions for OID on Original Issue Discount Convertible Debentures ("OIDCDs") for a number of reasons more fully described below. To summarize:

- The Treasury's conclusion that the marketplace treats OIDCD as de facto equity is erroneous and inconsistent with clearly observable facts;
- In an attempt to draw a distinction between OIDCDs and traditional convertible debt, Treasury has in prior years misstated current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures, and apparently continues to rely on such misstatements;
- The proposal ignores established authority that treats OIDCDs as debt, including guidance from the IRS in the form of a private letter ruling;
- The proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock;
- The proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Administration offers no rationale for repealing this principle;
- The proposal disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, the Administration's proposal would hastily reverse the results of years of careful study; and
- While billed as a revenue raiser, it is clear that adoption of the Administration's proposal would in fact reduce tax revenue.
- Finally, this proposal has been fully considered by this same Congress and rejected in prior years.

A. Treasury's Conclusion That The Market Treats OIDCD As De Facto Equity Is Erroneous And Inconsistent With Clearly Observable Facts.

The proposal is based on demonstrably false assumptions about market behavior, which assumptions are also inconsistent with clearly observable facts. *There is no uncertainty in the marketplace regarding the status of OIDCDs as debt*. These securities are booked on the issuers' balance sheets as debt, are viewed as debt by the credit rating agencies, and are treated as debt for many other legal purposes, including priority in bankruptcies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with OID as debt, not equity. Accordingly, *it is clear that the market's "view" supports the treatment of OIDCD as true debt for tax purposes*.

Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Because OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which have been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

The instruments in question are truly debt rather than equity. An analysis of 97 liquid yield option notes ("LYONs") sold in the public market between 1985 and 1998, shows that 57 of those issued had already been retired (as of December 1997). Of those 57, only 15 were finally paid in stock. The other 42 were paid in cash. The remaining 40 of the 97 issues were still outstanding as of December 31, 1997. If those 40 securities were called, only 19 of them would have converted to stock and the other 21 would have been paid in cash. In other words, the conversion features of only 19 of the 40 issues remaining outstanding are "in the money." Overall, only 35% of the public issuances of LYONs had been (or would be if called) paid in stock. Thus, in only 35% of these OIDCD issuances had the conversion feature ultimately controlled.

On the other hand, an analysis of 669 domestic issues of "typical" convertible debt retired since 1985 shows just the opposite result (as of December 1997). Seventy-three percent (73%) of these offerings converted to the issuer's common stock. Accordingly, based on historical data, typical convertible debt is significantly more likely to be retired with equity than cash, as compared to LYONs.

The Treasury's proposal is clearly without demonstrable logic. It makes no sense to say that an instrument that has approximately a 30% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore, the deduction for OID on that instrument should be deferred (or denied), while an instrument that has over a 70% probability of conversion should be treated for tax purposes as debt.[3] We would be happy to provide this data, and any other relevant information, to the Administration and Congress.

B. Prior Misstatements of Current Law Continue to Be Relied Upon

In prior year's Budget proposals, Treasury's has made statements of "Current Law," which apparently continue to be relied upon in its FY 2000 Budget. These statements misstate the law regarding interest that is accrued but unpaid at the time of the conversion. The Treasury has in the past suggested that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. Both the Treasury's own regulations and case law require that stated interest on a convertible bond be treated the same as OID without regard to whether the bondholder converts.

When the Treasury finalized the general OID regulations in January, 1994 (T.D. 8517), the Treasury also finalized Treasury Regulations section 1.446–2 dealing with the method of accounting for the interest. The regulations state:

> "Qualified stated interest (as defined in section 1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods)." See, Treas. Reg. Section 1.446–2(b).

All interest on a debt obligation that is not OID is "qualified stated interest." Treasury regulations define "qualified stated interest" under Treas. Reg. Section 1.1273–1(c) as follows:

> (i) In general, qualified stated interest is stated interest that is unconditionally payable in cash or in property . . . or that will be constructively received under section 451, at least annually at a single fixed rate . . .
>
> (ii) Unconditionally payable . . . *For purposes of determining whether interest is unconditionally payable, the possibility of a nonpayment* due to default, insolvency or similar circumstances, or *due to the exercise of a conversion option described in section 1272–1(e) is ignored*. This applies to debt instruments issued on or after August 13, 1996 (emphasis added).

Thus, according to the Treasury's own regulations, fixed interest on a convertible bond is deductible as it accrues without regard to the exercise of a conversion option. The Treasury's suggestion to the contrary in the description of the Administration's proposal contradicts the Treasury's own recently published regulations.

In addition, case law from the pre-daily accrual era established that whether interest or OID that is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In *Bethlehem Steel Corporation v. United States*, 434 F.2nd 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. The indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the *Bethlehem Steel* court's opinion and thus, the indentures for all

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[3] Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

of these offerings provide that if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID.

Thus, there is no tax law principle that requires a difference between "typical" convertible bonds and zero coupon convertible deductions. The only difference is a matter of indenture provisions and that difference has been overridden by the Treasury's own regulations.

C. Proposal Ignores Established Authority That Treats OIDCDs As Debt, Including Guidance From The IRS In The Form Of A Private Letter Ruling.

Under current law, well-established authority treats OIDCDs as debt for tax purposes, including guidance from the IRS in the form of a private letter ruling. The IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. See, PLR 9211047 (December 18, 1991). Obviously rather than having not exploited [a] lack of guidance from the IRS, issuers of OIDCDs have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. If any such ambiguity existed the IRS would not have issued its ruling.

D. Proposal Is Inconsistent With The Fundamental Principle That Payment In Stock Is Equivalent To Payment In Cash.

We would now like to focus not on the timing of the deduction but on the portion of the Administration's proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law that treats a payment in stock the same as a payment in cash. A corporation that issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation that issues stock to pay rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(8)[4] to repeal case law that allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(8) clearly defines the tax result of retiring debt for stock. As long as the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Administration's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same as payment with cash. The Administration's proposal would create an inconsistency without any reasoned basis.

E. Treasury's Proposal Removes The Long Established Principle Of Tax Symmetry Between Issuers And Holders Of Debt With OID.

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling, cited above, confirms this result. It is important to note that the OID rules were originally enacted to ensure proper timing and symmetry between income recognition and tax deductions for tax purposes. Proposals that disrupt this symmetry violate this fundamental goal of tax law.

The Administration's proposal reverses the policy of symmetry between issuers and holders of OID obligations. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Administration's proposal removes this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have an offsetting deduction. The Administration does not offer any justification for this unfairness.

F. Treasury's Proposal Is An Arbitrary Attempt To Reverse Tax Policies That Were Adopted After Nearly A Decade Of Careful Study.

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting

[4] All section references are to the Internal Revenue Code of 1986, as amended.

1982 and 1984 changes in the Internal Revenue Code regarding OID, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. *See,* 51 Federal Register 12022 (April 18, 1986).

This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton Administrations. Comments from the public were studied and hearings were held by the current administration on February 16, 1993. When the current Treasury Department adopted final OID regulations in January of 1994, the final regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three Administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID relating to convertible debentures. Merrill Lynch suggests that it is not wise policy to reverse a tax policy that Treasury had adopted after nearly a decade of study and replace it with a policy previously rejected by Congress on a number of occasions.

G. Proposal Regarding OID Convertible Debentures Would Reduce Tax Revenue.

While billed as a "revenue raiser," adoption of the Administration's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This a priori view is supported by the historical analysis of OIDCDs indicating that over 70% have been, or if called would be, paid off in cash.
- If OIDCDs were no longer economically viable, issuers would issue straight debt.
- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.
- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less that 30% of OIDCDs held by such accounts.

Consequently, the empirical data suggests that if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. The Administration's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, Merrill Lynch believes rejection of the proposal with respect to OIDCDs is warranted and the reasons for doing so compelling.

III. *PROPOSAL TO ELIMINATE THE DRD ON CERTAIN PREFERRED STOCK.*

The Administration has proposed to deny the 70-and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate, commodity price or similar benchmark. A similar proposal was proposed and rejected by Congress a number of times in the past three years.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit savings, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, the Administration's proposal to eliminate the DRD on certain stock would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation.

From an economic standpoint, Merrill Lynch believes that in addition to exacerbating multiple taxation of corporate income, the Administration's proposal is troubling for a number of reasons and would have a number of distinct negative impacts:

- *Dampen Economic Growth.* If the DRD elimination were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital, would see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.
- *Limit Competitiveness of U.S. Business*. The elimination of the DRD would also further disadvantage U.S. corporations in raising equity vis-a-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, govern-

ments have adopted a single level of corporate taxation as a goal, and inter-corporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double-or triple-taxation regime, they will remain at a distinct competitive disadvantage.

• *Discriminate Against Particular Business Sectors and Structures*. The Administration's proposal may have a disproportionate impact on taxpayers in certain industries, such as the financial and public utility industries, that must meet certain capital requirements. Certain types of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not have the option to retain income to lessen the impact of multiple levels of taxation.

• *Companies Should Not Be Penalized for Minimizing Risk of Loss*. As a result of the Administration's proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may well choose to curtail these risk management programs.

• *No Tax Abuse*. In describing the DRD proposal, the Administration suggests that some taxpayers "have taken advantage of the benefit of the dividends received deduction for payments on instruments that, while treated as stock for tax purposes, economically perform as debt instruments." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of eliminating the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity.

While the overall revenue impact of the DRD proposal may be positive, Merrill Lynch believes the revenue gains will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

• *Issuers of Preferred Stock*. Eliminating the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.

• *Secondary Market for Preferred Stock.* Currently, the market for outstanding preferred stock is divided into two segments:

—A multi-billion dollar variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the elimination of the DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.

—A multi-billion dollar fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings given the increased taxation. Individual investors will bear the brunt of any price decline, because they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in a revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to eliminate the DRD on certain limited-term preferred stock. Any such action will make "triple taxation" even more pronounced in, and burdensome on, our economy.

V. *CONCLUSION*

Based on the discussion set forth above, Congress should reject the Administration's proposals out of hand. These proposals which include the deferral of legitimate interest deductions and the elimination of the DRD are nothing more than tax increases which raise the cost of financing new investments, plant, equipment, research, and other job-creating assets. These tax increases hurt the ability of American companies to compete against foreign counterparts and are born by the millions of middle-class Americans who try to work and save through their retirement plans and mutual fund investments. These impediments to investment and savings would hurt America's economic growth and continued leadership in the global economy. At a time of budget surpluses, the last thing Congress should be considering are increased taxes on capital markets.

Moreover, from a tax policy perspective, the Administration's proposals are ill-advised, arbitrary and capricious tax law changes that have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals are nothing more than ad hoc tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of certain debt instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

The Administration's proposals also are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are—nothing more than tax increases on Americans.

For all the reasons stated above, the Administration's proposals should *AGAIN* be rejected in toto.

Statement of National Association of Life Underwriters (NALU), and Association for Advanced Life Underwriting (AALU)

The National Association of Life Underwriters (NALU) and the Association for Advanced Life Underwriting (AALU) submit this statement strongly opposing the Administration's Fiscal Year 2000 budget proposal that imposes new taxes on the business uses of life insurance. NALU represents more than 104,000 life insurance agents, most of them rank-and-file professionals, around the country. AALU, a conference of NALU, represents those whose businesses focus on specialized life insurance applications in business, employee benefits, and estate planning situations. Together, NALU and AALU represent the interests not only of our more than 100,000 life and health insurance professionals, but also the millions of individuals and businesses that own life insurance.

Currently, thousands of businesses—small and large—own life insurance that protects them and millions of people they employ from major financial hardship resulting from the death of key persons. Business life insurance also enables businesses to attract, retain and provide benefits to current and retired employees. Such critically important and long-standing business uses of life insurance should not be disturbed. We therefore urge Members of the Ways and Means Committee to reject the Administration's proposal, which would effectively eliminate these essential business, job and benefit protections by imposing a major tax disincentive for purchasing life insurance or continuing to keep current policies in force.

Administration's Proposal Is a Broad Attack on the Vast Majority of the Business Uses of Life Insurance and Unfairly Categorizes Traditional Uses as "Corporate Tax Shelters."

The Administration's proposal would be devastating in its economic effects. Specifically, it would impose a tax penalty—directly based on accumulating cash value—on businesses that own life insurance and have any debt whatsoever. The only exception would be for policies covering 20 percent or greater owners.

For example, consider a small partnership of 10 equal owners. The partnership carries key person insurance on its principal rainmaker. It also has a bank loan, secured by its accounts receivable, taken out to pay for new, updated office equipment. Under the Clinton proposal, this partnership would have to reduce its deduction for interest paid on the office equipment loan just because it carries life insurance on one of its owners. The bank loan for office equipment is in no way connected to the life insurance, yet the deductible interest on that loan is affected by the Clinton proposal. This is inherently unfair. It puts the partnership in a position of having to pay a tax penalty for its decision to carry permanent life insurance for a long-standing, traditional life insurance purpose.

Businesses have the need, at various times, both to own permanent life insurance and to borrow. Given the fact that life insurance represents a long-term investment of perhaps forty years, any automatic tax penalty imposed on businesses that own permanent life insurance and which engage in unrelated borrowing will seriously undermine business uses of life insurance and the benefits that they provide.

Almost as disturbing as the business life insurance proposal itself, is the fact that the proposal is included within the "corporate tax shelter" portion of the Administration's budget. Such common business uses of life insurance as key-person protection, buy-sell agreements, split dollar, deferred compensation and employee benefits serve very important functions and should certainly *not* be characterized as tax shelters.

The Administration's characterization of the business uses of permanent life insurance as tax shelters may well betray an inappropriate, negative bias against the product. The Administration proposes broadening the definition of what constitutes a tax shelter, but even under this looser standard, the Administration states that a tax shelter does not include "a tax benefit clearly contemplated by the applicable provision." Department of Treasury, General Explanation of the Administration's Revenue Proposals at 96 (February 1999).

It would be hard to argue that the tax attributes of the business uses of life insurance are not clearly contemplated, given the fact that Congress has examined such uses and such tax attributes in each of the past four years, and enacted legislation covering such uses in 1996 and 1997. In fact, in 1997 Congress made a clear decision *not* to apply the tax penalty now proposed, where the life insurance policies cover the lives of officers, directors, employees or twenty or greater percent owners.

Current Law Sets Appropriate Standards for Business Life Insurance

In 1996, Congress largely eliminated the ability of businesses to deduct interest on loans associated with life insurance. This general rule applies whether the business borrows directly from a life insurance policy or borrows indirectly by pledging the life insurance policy as collateral for a loan. It also applies if there is a demonstrable connection between the decision to purchase life insurance and the decision to borrow and deduct interest.

The only exceptions from this business life insurance loan disallowance are for (1) contracts purchased on or before June 20, 1986 or (2) contracts covering key persons, provided the indebtedness is not greater than $50,000 per insured life and the total number of such persons cannot exceed the greater of (a) 5 or (b) the lesser of (i) 5 percent of total officers and employees or (ii) 20.

In 1997, after a well-publicized intent by Fannie Mae to initiate a multibillion dollar program of purchasing permanent life insurance on the lives of mortgage borrowers, Congress enacted legislation, which for the first time and under very narrow circumstances, disallowed otherwise deductible interest without first requiring a link between the decisions of a business to purchase life insurance and to borrow money.

NALU and AALU did not oppose this legislation because we understood a Congressional disapproval of the expansion of the use of permanent life insurance by businesses beyond a long-established utilization to cover the lives of owners, officers, directors and employees. We appreciated that Congress was surgical in structuring the legislation to prevent a widespread new use of permanent life insurance to cover borrowers, while causing little disturbance to the long-standing ability of businesses to use permanent life insurance to protect themselves, their 20 percent or greater owners, officers, directors and employees and to provide benefits for them. We reluctantly yielded on the point that it's unfair to penalize life insurance ownership because of a business's decision to borrow for reasons and using assets *unrelated* to life insurance. Despite our deeply-rooted conviction that tying insurance ownership to unrelated loan interest is inherently unfair and wrong, we understood Congress' goal was to prevent the expansion of the use of life insurance outside of the employment context.

In 1999, for the second year in a row, the Clinton Administration budget proposal includes a provision which would broadly impose the tax penalty which is now narrowly targeted on business uses of life insurance covering individuals like mortgage borrowers, who are *not* 20 percent or greater owners, officers, directors or employees. Nothing is said in the proposal that would justify this devastating and ill-advised departure. Businesses which utilize permanent life insurance to insure their key persons should not be penalized because they engage in unrelated borrowing.

Current Business Uses of Life Insurance which would be Hit by the Administration Proposal

The Administration's proposal would impose a tax penalty on all current and future policyholders, except those covering twenty percent or more owners, and would penalize life insurance used for the following traditional purposes. The following examples illustrate why it is essential that the Administration's proposal be rejected:

• Successful continuation of business operations following the death of an insured key employee.

Virtually every business has one or more employees whose production is critical to the business' financial health. It could be key management personnel, or perhaps it is the salesperson who brings in the work for the business to perform. Other examples include those whose jobs demand the creativity of product development, a marketing initiative or a merger or acquisition, the success of which depends heavily on the continued personal involvement of these individuals. Or it may be the extra-skilled technician who knows how to work the crucial computer or manufacturing system that is the heart of the business' performance.

There are very many situations in which such individuals are *not* twenty or greater percent owners.

When one or more of these individuals die, the business faces the enormous cost of replacing these workers' individual skills. During the time when a replacement is sought and during the "learning curve" period when the new worker(s) get up to speed, the firm is likely to lose both new business and productivity with respect to existing business. In this so-called "key person" scenario, it is this measurable loss that life insurance death benefits replace.

• Purchase of a business interest, thereby enabling the insured's family to obtain a fair value for its business interest and permitting the orderly continuation of the business by its new owners or the redemption of stock to satisfy estate taxes and transfer costs of an insured stockholder's estate.

Life insurance protects businesses against the financial devastation that occurs when one of several business owners dies. The buy-sell or stock redemption involves the use of life insurance to pay the decedent owner's heirs the decedent's ownership interest. This avoids the use of business assets—which may not be in liquid form—to meet this obligation. Without the use of business life insurance for these purposes, either the decedent's heirs will become potentially active participants in the business as they exercise their new ownership rights, or—in the worst case—the business itself might have to be sold in order to satisfy the financial obligation to the decedent owner's heirs.

In each of these scenarios, the existence of death benefits could very well spell the difference between the continued operation of the business and its failure. The continued operation of the business, of course, means the continuation of the jobs that the business provides to its employees, and the continuation of the business's impact on other businesses in the community. It also means that the business will continue to pay its income taxes to the Federal and state governments and to contribute to our overall economic growth.

As with the case of key person insurance, there are many needs for a business to utilize life insurance for buy-sell or stock redemption purposes, which involve owners who have less than a twenty percent interest in the entity.

• Creation of funds to facilitate benefit programs for long-term current and retired employees, such as programs addressing needs for retirement income, post-retirement medical benefits, disability income, long-term care or similar needs. Payment of life insurance or survivor benefits to families or other beneficiaries of insured employees. Facilitation of employee ownership of and benefits from permanent life insurance death and retirement income protection through split dollar arrangements.

The success of any business is contingent on attracting and retaining the employees that it needs, through appropriate compensation and benefit packages. This can be particularly difficult in situations addressed by the Administration's proposal—individuals who have no ownership interest or an interest of less than twenty percent. Life insurance, through the above means, provides effective ways for businesses to hire and retain a high quality workforce. Providing employee benefits is especially difficult for small businesses, and life insurance offers the flexibility and cost feasibility that makes it possible.

CONCLUSION

In conclusion, NALU and AALU urge Congress to reject the Administration's misconceived proposal on business life insurance. The business use of life insurance is *not* a tax shelter; it protects businesses against the loss of key persons, provides for the orderly continuation of businesses and facilitates the ability of businesses to attract and retain quality employees.

Thank you.

Statement of National Association of Manufacturers

INTRODUCTION

The National Association of Manufacturers (NAM) appreciates the opportunity offered by Committee Chairman Archer to comment on the revenue provisions in the Administration's FY 2000 budget proposal. The NAM is the nation's largest national broad-based industry trade group. Its 14,000 member companies and subsidiaries, including approximately 10,000 small manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. The NAM's member companies and affiliated associations represent every industrial sector and employ more than 18 million people.

The NAM believes that federal taxes are too high and too complex, making the current federal tax code the single biggest obstacle to economic growth. Congress should pursue a comprehensive overhaul of the federal tax code that would not only make it simpler, but would also stimulate—rather than penalize—the generation of income from work, saving, investment and entrepreneurial activity. Until such reform goes into effect, the NAM will seek a major reduction in taxes to stimulate job creation and economic growth—preferably an across-the-board cut in all federal income tax rates of at least 10 percent. The NAM also supports targeted relief such as a permanent and strengthened R&D tax credit, "death-tax" repeal, repeal of the corporate Alternative Minimum Tax, S-corporation tax rate relief, capital gains tax relief, international tax simplification, and other pro-growth changes.

We commend the Administration's support for several pro-growth tax incentives, including an extension of the R&D tax credit. On balance, however, the Administration's budget proposal enlarges the size and scope of the government but fails to advance broad, pro-growth tax reductions. Moreover, the majority of the revenue raisers in this budget would restrict growth and constitute bad tax policy. Overall, the proposals run counter to the NAM's goal of maintaining sustained economic growth to enhance living standards for all Americans. Although this is not an exhaustive list, following are the NAM's comments on some of the specific provisions.

PRO-GROWTH PROPOSALS

TAX CREDIT FOR RESEARCH AND EXPERIMENTATION (R&D TAX CREDIT)

The NAM is pleased that the Administration included an extension of the R&D tax credit in its fiscal year 2000 budget proposal, but is disappointed that the extension is only for 12 months. By expiring mid-year, a 12-month extension results in unnecessary tax complexity. We urge Congress and the Administration to act on a permanent, seamless extension of this important tax incentive.

The importance of R&D cannot be overstated. Increased productivity, new product development and process improvements are direct results of technological advances that occur from R&D activities. Notably, nearly two-thirds of the growth in manufacturing and up to one-third of the growth in the overall economy can be attributed to technological advances.

An NAM economic analysis shows that a permanent R&D tax credit would actually increase the rate of GDP growth over the long term, as opposed to a one-time shift in the level of GDP. This is an important distinction from most policy initiatives, which have no effect on the rate of long-term economic growth. Many of our nation's foreign-trade competitors offer permanent tax and financial incentives for R&D; the credit helps mitigate this competitive disadvantage of U.S. companies.

We urge Congress and the President to work together to end more than 15 years of temporary lapses with extensions that may or may not be retroactive to the expiration date. The NAM strongly supports ending the uncertainty of credit extensions by making the R&D tax credit permanent. In addition, the alternative incremental research credit (AIRC) should be further expanded so businesses can better rely on and utilize the credit. The NAM supports legislation (H.R. 835) introduced by Representatives Johnson (R–CT–6) and Matsui (D–CA–5) and (S. 680) introduced by Senators Hatch (R–UT) and Baucus (D–MT) that permanently extends the R&D tax credit and increases the AIRC.

EXCLUSION FOR EMPLOYER-PROVIDED TUITION ASSISTANCE

The NAM applauds the Administration's proposal to extend the current Section 127 exclusion for employer-provided tuition assistance through the end of 2002, and expand the tax benefit to cover graduate education beginning in July 1999. It is our hope that Congress will make Section 127 permanent, in order to help companies and their employees better prepare for the growing challenges of the modern workplace.

We strongly believe that education and lifelong learning are the key to continued economic growth and worker prosperity. Our economy will continue to grow only if our workers are armed with the skills they need to thrive in tomorrow's workplace. Expansion and extension of the exclusion for employer-provided education assistance is a welcomed proposal.

Look-Through Treatment for 10/50 Companies

The NAM supports the Administration's proposal to accelerate the effective date of a provision in the 1997 Tax Relief Act affecting foreign joint ventures where U.S. persons own at least 10 percent, but not more than 50 percent, of the stock (so-called "10/50 companies"). This change would treat 10/50 companies like controlled foreign corporations by allowing "look-through" treatment, for foreign tax-credit purposes, of dividends from such joint ventures. Under the 1997 Act, the change is effective only for dividends received in tax years beginning after 2002. In addition, two sets of rules apply: one for dividends from pre–2003 earnings and profits (E&P); another for dividends from post–2002 E&P. The Administration's proposal would instead apply the look-through rules to all dividends received in tax years beginning after 1998, regardless of when the E&P accumulated.

The proposal would reduce the tremendous complexity and compliance burdens faced by U.S. multinationals doing business overseas through foreign joint ventures. It would also reduce the competitive bias against U.S. participation in foreign joint ventures by placing U.S. companies on a much more level playing field from a corporate-tax standpoint. In sum, it would provide sorely needed simplification of the tax laws and would go a long way toward helping the U.S. economy by strengthening the competitiveness of U.S.-based multinationals. The NAM withholds its support for the proposed grant of regulatory authority regarding pre-acquisition earnings and profits subject to greater clarification of what rules are contemplated.

Tax Incentives To Promote Energy Efficiency and Improve the Environment

In general, the NAM supports a voluntary approach for private sector research to improve energy efficiency and the environment, rather than federal mandates. While the NAM generally approves of the thrust of the Administration's tax-incentive proposals pertaining to energy efficiency, the manufacturing community would prefer a permanent extension of the current R&D tax credit to better allow the market to allocate limited resources in this area.

ANTI-GROWTH PROPOSALS

Corporate

General Corporate Tax Planning

The NAM is concerned about the Administration's attack on legitimate corporate tax planning. The Administration's proposals to address what it labels as "tax avoidance transactions" are overly broad and would bring within their net many corporate transactions that are clearly permitted under existing law. Legitimate tax planning to conform to domestic and foreign non-tax legal or regulatory requirements could well be subject to confiscatory penalties for failing to satisfy these overly broad standards. In particular, the Administration would impose strict liability for a confiscatory 40-percent penalty on taxpayers entering into transactions that IRS agents determine are uneconomic. The fact that the taxpayer acts reasonably and in good faith, or has a substantial business purpose for the transaction would not matter. This is simply not the right standard. Our business transactions and the tax laws that apply to them are too complex. Taxpayers and the government inevitably will disagree. Taxpayers should be allowed to assert their views as freely as IRS agents assert theirs.

To function efficiently and productively, business taxpayers must be able to rely on the tax code and existing income-tax regulations. If the Administration's vague "tax-shelter" proposals become law, few businesses would feel comfortable relying on those statutes or regulations. Treasury's proposed rules could cost the economy more in lost business activity than they produce in taxing previously "sheltered" income.

In sum, the Administration's attempt to tilt the playing field in favor of the IRS would make it very difficult for taxpayers to engage in a number of legitimate transactions. These actions would hurt the ability of U.S. corporations to operate economically and to compete effectively against their foreign-based competitors. At the same time, though, there are some abusive transactions that need to be addressed. The NAM would welcome the opportunity to work with Congress and the Administration to resolve these issues.

Tracking Stock

Under the Administration's budget, the issuance of "tracking stock" would be taxable to the issuer based on the gain in the tracked assets. "Tracking stock" is a class of stock on which dividends are payable and other shareholder rights are determined with respect to a distinct business unit that represents less than all the assets of the issuing corporation. The NAM opposes this attempt by Treasury to trigger a double tax on corporate income.

Tracking stock has been used in a number of circumstances for compelling business reasons and not for tax-avoidance purposes. It is an efficient means of raising capital. Moreover, with tracking stock, investors can choose the specific operations of a corporation in which to invest, rather than investing in a corporate conglomerate. Tracking stock also is effective in promoting employee incentives and accountability for employees working in the "tracked" operation, and facilitates the acquisition of a new business or the expansion of an existing business. If enacted, this proposal would adversely impact existing tracking-stock values and preclude future use of this valuable type of security.

Tax Treatment of Downstream Mergers

The NAM also opposes the Administration's proposal to change the tax treatment of certain downstream mergers. Downstream mergers generally involve a parent corporation (target) that holds stock in a subsidiary company (acquiring). The Administration's proposal would apply in cases where the target company does not satisfy the stock-ownership requirements of Section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to the acquiring corporation, and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor. In these cases, the target corporation must recognize gain, but not loss, on the acquiring corporation stock it distributes to shareholders immediately before the reorganization. The proposed change would eliminate a longstanding and well-recognized ability of companies to reorganize in a tax-free manner.

Debt-Financed Portfolio Stock

The NAM opposes the Administration's proposal to modify the standard for determining whether portfolio stock is debt-financed. This provision would effectively reduce the dividends-received deduction (DRD) for any corporation carrying debt (virtually all corporations) and would specifically target financial-service companies, which tend to be more debt-financed.

The purpose of the DRD is to eliminate, or at least alleviate, the impact of potential multiple layers of corporate taxation. Under current law, the DRD is not permitted to the extent that relevant "portfolio stock" is debt-financed. Portfolio stock is defined as stock in which the corporate taxpayer owner holds less than 50 percent of the vote or value. Portfolio stock has generally been treated as debt-financed when it is acquired with the proceeds of indebtedness or secures the repayment of indebtedness. The Administration's proposal would expand the DRD disallowance rule for debt-financed stock by assuming that all corporate debt is allocated to the company's assets on a pro-rata basis. Thus, the proposal would partially disallow the DRD for all corporations based on a pro-rata allocation of its corporate debt.

We believe the proposal would exacerbate the multiple taxation of corporate income, penalize investment and mark a retreat from efforts to develop a fairer, more rational and simpler tax system. The NAM believes that multiple taxation of corporate earnings should be reduced, rather than expanded. The Administration's proposal clearly moves in the wrong direction.

Dividends-Received Deduction for Certain Preferred Stock

Another proposal would deny the dividends-received deduction (DRD) on stock that the Administration believes is more like debt than equity. This has been both proposed by the Administration and rejected by Congress in the past. The NAM objects to this provision since it is not in the best interests of tax or public policy.

As noted above, the DRD was designed to alleviate the impact of multiple layers of corporate taxation. Without the DRD, income would be taxed three times: when it is earned by a corporation; when the income is paid as a dividend to a corporate shareholder; and when the income of the receiving corporation is paid as a dividend to an individual shareholder. The DRD was enacted to provide for full deductibility of intercorporate dividends.

Although the Administration is concerned that dividend payments from certain preferred stock more closely resemble interest payments than dividends, the proposal would not allow issuers of this preferred stock to take interest expense deductions on the dividend payments. This proposal, which would deny these instruments the tax benefits of both debt and equity, would violate sound tax policy.

Corporate-Owned Life Insurance (COLI) Rules

The NAM opposes the Administration's proposal to repeal an exception to the current proportionate interest disallowance rules for contracts on employees, officers or directors, other than 20-percent owners of the business. This proposal has been included in earlier Administration budgets and rejected by Congress in the past. This exception was designed to allow employers to create key-person life-insurance programs, fund non-qualified deferred compensation with the advantages of life insurance and meet other real business needs. The proposal would tax the inside buildup in cash-value life insurance owned by a business that also has debt. Given the long-term nature of life-insurance investments, this rule would make insurance unattractive even to companies that currently have no debt because they might need to borrow at some future date.

Deferral of Original Issue Discount (OID) on Convertible Debt

The Administration's budget includes a number of past proposals aimed at financial instruments and capital markets, which were fully rejected by previous Congresses. These recycled proposals should be rejected again. One proposal would defer deductions by corporate issuers for interest accrued on convertible-debt instruments with original issue discount (OID) until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g., no deduction would be allowed if the investors convert their bonds into stock). Investors in these instruments still would be required to pay income tax currently on the accrued interest. In effect, the proposal would defer or deny an interest deduction to the issuer while requiring the holder to pay tax on the interest currently.

The NAM opposes this proposal because, by failing to match the accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest, it is contrary to sound tax policy. Moreover, there is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

General Business

Deductibility of Punitive Damages

The Administration proposes to make punitive-damage payments in civil suits non-deductible, whether made in satisfaction of a judgment or in settlement of a claim. In addition, punitive damages paid by an insurance company on a taxpayer's behalf would be includable in the gross income of the taxpayer. The NAM strongly urges Congress to reject this provision.

Currently, punitive-damage payments are deductible by a business and are generally includable in the gross income of the recipient. In many states, the present punitive-damage system has been characterized in recent years by dramatic increases in the number and size of punitive-damage awards and is badly in need of reform. There is a need for better and more uniform standards and guidelines on when punitive damages can be awarded and the size of the awards. There are wide differences in standards among the states. Thus, the proposal would treat essentially similar conduct differently, depending on where it occurs.

The Administration's proposal would exacerbate all the problems of the current punitive-damage system, effectively increasing the size (cost) of awards and settlements and having a chilling effect on productive commercial activity. The proposal also would provide plaintiffs' attorneys with greater leverage to extract settlements of deductible compensatory damages in lieu of threatened non-deductible punitive damages. In short, the proposal would change the nature of settlement negotiations to minimize the "tax take" of the government, which would be an undesirable feature for any civil justice system. The proposal also would deny businesses the ability to deduct ordinary and necessary business expenses relating to legal claims.

Finally, the proposal to eliminate the deductibility of civil punitive-damage awards raises strong concerns, especially given Congress's continued failure to reform the civil-justice system, and the inappropriate comparison that proponents have made with the non-deductibility of criminal fines and penalties. It would be unfair to eliminate the deduction for civil punitive-damage awards in the absence of any meaningful reform of the civil-justice system.

Superfund Taxes

The Superfund program has been funded historically by the corporate environmental income tax and excise taxes on petroleum, chemical feedstock and imported chemical substances, all of which expired on Dec. 31, 1995. The Administration's budget proposal would reinstate the excise taxes for the period after the date of enactment and before Oct. 1, 2009. The corporate environmental income tax would be reinstated for tax years beginning after Dec. 31, 1998, and before Jan. 1, 2010. The Administration has tried to reinstate these taxes in the past, although earlier attempts were rejected by Congress. The NAM opposes these proposals.

Under the "pay-go" rules of the federal budget laws, any Superfund reauthorization bill that includes new spending must also include offsets, i.e., the reinstated Superfund taxes or equivalent revenues "within the four corners of the bill." Thus, as a practical matter, an extension of the Superfund taxes separate from a Superfund reauthorization bill may preclude the possibility of a major legislative reform of the Superfund program during the period when the taxes are reinstated. The NAM urges Congress only to consider reinstating these taxes as part of meaningful reform of the Superfund program. The extension of Superfund taxes without changing the existing Superfund regime only exacerbates a serious problem.

Deposit Requirements for Unemployment Insurance Taxes

The NAM opposes a provision in the Administration's budget that would accelerate, from quarterly to monthly, the collection of most federal and state unemployment-insurance (UI) taxes. Imposing a monthly collection of federal and state UI taxes would accelerate the collection of taxes to generate a one-time, artificial revenue increase for budget-scoring purposes. At the same time, though, the change would permanently increase both compliance costs for employers and collection costs for state unemployment insurance administrators. The Administration's proposal is fundamentally inconsistent with every reform proposal that seeks to streamline the operation of the UI system, as well as the government's own initiatives to reduce paperwork and regulatory burdens. This deposit acceleration rules makes no sense for small or large businesses, and an exemption for certain small businesses would not improve this fundamentally flawed concept.

Tax Treatment of Start-Up and Organizational Expenses

Under current law, start-up and organizational expenditures are amortized at the election of the taxpayer over a period of not less than 60 months. In contrast, a 15-year amortization period applies to certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business, or an activity for the production of income. The NAM opposes the Administration's proposal to extend the amortization period from 5 to 15 years for start-up and organizational expenditures incurred by certain businesses. Although a de minimis rule would allow businesses to deduct up to $5,000 a year of these costs, this benefit would be phased out as total expenditures exceed $50,000. The NAM believes that the proper treatment of many start-up and organizational expenses in a neutral tax system would be expensing. Moving in the opposite direction, toward a longer artificial recovery period for such expenses, would simply increase taxes on companies that are growing and expanding.

Inventory Accounting Methods

The NAM opposes the Administration's proposal to repeal two inventory-accounting methods. This proposal was included in earlier Administration budget plans and rejected by Congress. A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting the taxpayer's inventory at the end of the period. Because of the difficulty of applying the specific identification method of accounting, taxpayers often use methods such as "first-in, first-out" (FIFO) and "last-in, first-out" (LIFO).

Certain taxpayers can currently determine their inventory values by applying the lower of cost or market (LCM) method, or by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other causes (the "subnormal-goods" method). The Administration would repeal these options and force taxpayers to recognize income from changing their method of accounting on the grounds that writing down unusable or unsalable goods somehow "understates taxable income." We urge Congress to reject this proposal. In addition, the NAM believes that the LCM method should continue to be permissible for financial-accounting purposes to avoid the complexity of maintaining separate inventory-accounting systems.

Substantial Understatement Penalty

Under the Administration's proposal, any tax deficiency greater than $10 million would be considered "substantial" for purposes of the penalty. In contrast, under the existing test, the tax deficiency must exceed 10 percent of the taxpayer's liability for the year. The Administration's proposal has been rejected by Congress in the past. The NAM also opposes the Administration's proposal to tighten the substantial understatement penalty.

For many individual taxpayers and even privately-held companies, $10 million may be a substantial amount of money. However, for a large, publicly held multinational company, $10 million may not be "substantial." Further, in view of the complexities and ambiguities contained in the existing tax code, a 90-percent accurate return should be deemed substantial compliance with only additional taxes and interest due and owing. There is no policy justification to apply a penalty to publicly held multinational companies that are required to deal with much greater complexities than other taxpayers.

Penalties for Filing Incorrect Information Returns

Similarly, the NAM opposes the Administration's proposal to increase penalties for failing to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for filing information returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to file timely returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

INTERNATIONAL

Export-Source Rule

The NAM strongly opposes the Administration's proposal to replace the current export-source rule with an activity-based sourcing rule. The proposal, which has been part of earlier budget plans, has been consistently rejected by Congress. The export-source rule, which has been included in tax regulations since 1922, applies in cases where goods manufactured in the United States are sold abroad. Under this rule, half of the income derived from these sales is treated as foreign-source income as long as title to the goods passes outside the United States. The export-source rule increases the ability of U.S. exporters to use foreign tax credits and avoid double taxation of foreign earnings.

The Administration contends that the export-source rule is not needed to alleviate double taxation because of our tax-treaty network. We strongly disagree. The United States has tax treaties with fewer than a third of all jurisdictions. More significantly, double taxation is generally caused by the many restrictions in U.S. tax laws on crediting foreign taxes paid on the international operations that U.S. companies must have to compete in the global marketplace. Among these restrictions are the allocation rules for interest and R&D expenses, the many foreign tax-credit "baskets" and the treatment of domestic losses.

The Administration also alleges that the export-source rule gives multinational corporations a competitive advantage over U.S. exporters that conduct all of their business activities in the United States. However, to compete overseas effectively, most U.S. manufacturers find that they must have operations in these foreign markets to sell and service their products. The supposed competitive advantage over a U.S. exporter with no foreign assets or employees is a myth. There are many situations in which a U.S. manufacturer with no foreign activities simply cannot compete effectively in foreign markets.

Moreover, this proposal could reduce Treasury revenues by encouraging U.S. exporters to move their operations offshore. Instead of exporting products from the United States, they may be able to manufacture them abroad to the extent of excess capacity in foreign plants. If even a small percentage of U.S. exporters made a switch, the proposal would fail to achieve the desired result, and taxes on manufacturing profits and manufacturing wages would go to foreign governments.

At present, the United States has too few tax incentives for exporters, especially compared to foreign countries with VAT regimes. The United States should be stimulating the expansion of exports. Given our continuing trade deficit, it would be unwise to remove a WTO consistent tax incentive for multinational corporations to continue making export sales from the United States. Ironically, this proposal could result in multinationals using existing foreign manufacturing operations instead of U.S.-based operations to produce export products. The NAM strongly urges Congress to retain the current export-source rule.

Foreign Built-In Losses

The NAM opposes a proposal in the Administration's budget that would require the Treasury Department to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." This provision also has been proposed by the Administration in the past and rejected by Congress. The Administration argues that, although there are rules limiting a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain, there are no similar rules to prevent taxpayers from using built-in losses to shelter income otherwise subject to U.S. tax. As a result, taxpayers are avoiding Subpart F income inclusions or capital-gains tax. We believe that this directive, which is written extremely broadly, is unnecessary because of existing rules in the Code. This proposal would severely impact the ability of U.S. multinationals to compete on an equal footing against foreign-based companies.

Foreign Oil and Gas Income Tax Credits

The NAM also opposes a provision in the Administration's budget that would limit the availability of foreign tax credits for certain foreign taxes paid on foreign oil and gas extraction income. Congress also has rejected the proposal in the past. This selective attack on a single industry's use of the foreign tax credit is not justified. U.S.-based oil companies are already at a competitive disadvantage under current law because most of their foreign-based competitors pay little or no home-country tax on foreign oil and gas income. The proposal would increase the risk that foreign oil and gas income would be subject to double taxation, severely hindering U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena. The NAM is particularly opposed to this provision because it undermines the entire foreign tax-credit system and sets a very bad tax-policy precedent by making the recoupment of double-taxation costs contingent on the industry in which a company is engaged.

Payments from 80/20 Companies

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax, provided the payor corporation is a so-called "80/20 company," i.e., at least 80 percent of its gross income for the preceding three years is foreign-source income attributable to the active conduct of a foreign trade or business.

The NAM opposes the Administration's proposed changes to the 80/20 rules. This Administration proposal has been rejected by Congress in the past. The Administration alleges that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, the Administration would apply the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past, and we do not believe such a drastic change is justified. Such a change also negatively impacts U.S. taxpayers operating as branches in foreign jurisdictions for legitimate business reasons.

Small and Medium Businesses

Conversions of C-Corporations to S-Corporations

The NAM opposes a provision to tax the conversion of a C-corporation to an S-corporation, which has been proposed by the Administration and rejected by Congress in the past. Under current law, the conversion of a C-corp to an S-corp generally is a tax-free event although the new S-corp must recognize built-in gain on former C-corp assets that are sold within 10 years of the conversion. Under a provision in the Administration's budget, however, the conversion of a C-corp to an S-corp would trigger taxes immediately.

The proposed tax law change represents a stark departure from the federal government's strong support for S-corps. S-corps were created more than 40 years ago to give owners of small and medium companies more flexibility in setting up and operating their businesses. This hybrid mix of a partnership and a corporation was specifically designed to encourage the growth and stability of small and medium businesses by allowing owners to maintain control of their companies while benefiting from the liability protections afforded corporate shareholders.

Small and medium companies, many of which are S-corps, are central to the growth of our economy. In fact, about one-fourth of our national income is generated by small and medium businesses. This proposal would effectively bar many businesses from becoming S-corps, and would have a particularly severe impact on small and medium companies. In contrast, the NAM urges Congress to act on S-corp rate-relief legislation, which would help mitigate some of the remaining deterrents for companies to convert to S-corporation status.

Treatment of ESOPs as S-Corp Shareholders

The NAM also opposes the Administration's proposal that would require an employee stock-ownership plan (ESOP) to pay tax on S-corp income (including capital gains on the sale of the stock) as the income is earned. The provision would reverse important reforms in the S-corp rules enacted in recent years and eliminate any incentive for S-corps to establish ESOPs.

Tax law changes enacted in 1996 and 1997 permit ESOPs to be S-corp shareholders. In addition, the ESOP's share of the S-corp's income is not subject to tax until it is distributed to plan beneficiaries. Under the proposal, however, an ESOP's S-corp income would be subject to the unrelated business income tax (UBIT) when the income is earned. The recent tax law changes enabled S-corp owners, for the first time, to set up ESOPs for their employees. The proposed changes would remove an important incentive for establishing and maintaining these plans.

Estate and Gift Tax Provisions

In the area of estate and gift taxes, the NAM opposes Administration proposals to scrap some techniques that allow a business owner to move illiquid assets out of the estate first. These proposals also have been rejected by Congress in the past. Forcing business owners to delay transfer of business ownership until death would result in an even higher failure rate for family-owned businesses.

The Qualified Terminable Interest Property Trust (QTIP) was designed by Congress to allow both spouses to use their full individual-unified credits. QTIPs were set up expressly to prevent the estate tax from impoverishing a surviving spouse. The proposed restrictions on the use of QTIPs would force an estate to choose between losing the unified credit, breaking up the business, or divesting the surviving spouse of cash, leaving the "second to die" holding the illiquid assets.

Personal Residence Trusts are significant tools for estate planners only because the family home is another illiquid asset. Allowing parents to give the family home to their children at a future date, while retaining the parents' right to live in the house for as long as they desire, permits a planner to give the estate the maximum liquidity to deal with the death tax bill.

Finally, the rules on minority valuation again produce little revenue gain, but they allow the IRS to decide whether the cash or cash equivalents of an active business exceed the "reasonable working capital needs of the business." This test is already defined under the accumulated-earnings tax, and it has been the subject of much litigation already.

Less than one-third of family businesses survive to the second generation. The Administration's proposals to further restrict estate-planning opportunities may raise minimal revenue, but would drive down the survival rate even further. The Treasury Department derides these estate-planning tools as legal fictions. However, estate and gift taxes themselves are bad. Family-owned businesses should not need to resort to legal fictions to stay in business. Federal estate and gift taxes should be abolished, not raised.

EXEMPT ORGANIZATIONS

Tax on Trade Association's Investment Income

The NAM strongly opposes the Administration's proposal to tax so-called "investment" income of trade associations, i.e., income associations receive from interest, dividends, rents, capital gains and royalties. Under the plan, all investment income greater than $10,000 earned by a trade association would be subject to the unrelated business income tax (UBIT).

It is difficult to underestimate the impact this proposed tax would have on associations. Associations rely on this income to carry out a wide range of exempt-status activities including education, training, research and community outreach. In addition, keeping investment income tax-free encourages organizations to maintain modest surplus funds from year to year, in order to remain stable during economic downturns. Unlike for-profit companies, associations cannot issue stock or seek money in public offerings to provide the necessary protection from fiscal crises. Moreover, the purpose of UBIT is to prevent associations and other tax-exempt organizations from competing unfairly against for-profit businesses. However, this investment income is not generated by activities that compete with tax-paying businesses. Rather, taxing trade association's investment income would impose an unjust and unnecessary penalty on legitimate association activities.

CONCLUSION: NEED FOR PRO-GROWTH TAX RELIEF

The NAM recognizes the importance and benefits of the existing surpluses in the federal budget. Clearly, the country's robust economic growth over the past seven years has been a key factor in moving the federal budget into a surplus position. Consequently, it is imperative that federal policies support continued economic growth. Unfortunately, most of the revenue raisers discussed above would discourage economic growth by providing disincentives to savings and investment and raising the cost of capital for manufacturers.

While the Administration's budget plan offers a few beneficial incentives, on balance it does not include any broad, pro-growth tax reductions. The NAM believes that there is room in the federal budget surplus for a broad-based tax cut. With the total federal tax take at record levels, tax rates should be lowered for all. If the surplus is not returned to taxpayers through tax cuts, it will likely go towards more government spending. In fact, without the "growth insurance" of a broad-based rate cut, the surplus itself could be in jeopardy because more growth yields more revenues to the federal treasury.

The NAM also believes there are a number of other pro-growth tax provisions that would benefit the American economy. These include a permanent and strengthened R&D tax credit, repeal of the "death" tax and the corporate Alternative Minimum Tax, reduction in S-corp tax rates on reinvested profits, international tax simplification and capital-gains tax relief for individuals and corporations.

Statement of Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts®

As requested in Press Release No. FC–7 (February 18, 1999), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Ways and Means Committee's review of certain revenue provisions presented to the Committee as part of the Administration's Fiscal Year 2000 Budget.

NAREIT's comments address the Administration proposals to (1) modify the real estate investment trust ("REIT") asset tests to permit REITs to own taxable REIT subsidiaries; (2) modify the treatment of closely held REITs; and (3) amend section 1374[1] to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for real estate companies. Members are REITs and other publicly-traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 200 REITs or other publicly-traded real estate companies, as well as over 2,000 investment bankers, analysts, accountants, lawyers and other professionals who provide services to REITs.

EXECUTIVE SUMMARY

Taxable REIT Subsidiaries. NAREIT welcomes the Administration's taxable REIT subsidiary proposal as a very significant step in the right direction to modernize the REIT rules. Current law requires REITs to use awkward methods in order to provide services to third parties, and also prevents REITs from remaining competitive in providing needed and emerging services to their tenants. The taxable REIT subsidiary structure would codify, yet simplify, the current law structure, while simultaneously allowing a REIT to provide new services to its tenants so long as these services are subject to a corporate level tax.

[1] For purposes of this Statement, "section" refers to the Internal Revenue Code of 1986, as amended.

As an alternative to the Administration's REIT subsidiary proposal, NAREIT recommends that Congress enact the Real Estate Investment Trust Modernization Act of 1999 being drafted by Representatives Thomas and Cardin (the "Thomas/Cardin Bill"). The Thomas/Cardin Bill would incorporate the principles of the Administration proposal, with four significant exceptions. First, The Thomas/Cardin Bill would require taxable REIT subsidiaries to fit within the current, unified 25 percent asset test, rather than the complex and cumbersome 5 and 15 percent assets tests under the Administration proposal. Second, the Thomas/Cardin Bill would limit interest deductions on debt between a REIT and its taxable subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intra-party interest deductions. Third, the Thomas/Cardin Bill would prohibit a taxable REIT subsidiary from operating or managing hotels, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at market levels, and (b) the rents are not tied to net profits, and (c) the hotel is operated by an independent contractor. Fourth, the Thomas/Cardin Bill would not apply the new rules on taxable REIT subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects taxable REIT subsidiary status. Conversely, the Administration proposal would apply to current arrangements after an undefined period of time.

Closely Held REITs. NAREIT supports the Administration's intention to craft a new ownership test intended to correspond to a REIT's primary mission: to make investment in income-producing real estate accessible to ordinary investors. However, we believe that the Administration's proposal is too broad, and therefore should be narrowed to prevent non-REIT C corporations from owning 50 percent or more of a REIT's stock (by vote or value). In addition, the new rules should not apply to so-called "incubator REITs" that have proven to be a viable method by which ordinary investors can access publicly traded real estate investments.

Built-in Gain Tax. Congress has rejected the Administration's call for a change in the section 1374 rules for three straight budgets. NAREIT recommends that Congress again reject this proposal. We also ask Congress to conduct oversight of the IRS to ensure that it does not do administratively what it has not been able to achieve by legislation.

BACKGROUND ON REITs

A REIT is essentially a corporation or business trust combining the capital of many investors to own and, in most cases, operate income-producing real estate, such as apartments, shopping centers, offices and warehouses. Some REITs also are engaged in financing real estate. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95 percent of their taxable income to shareholders;[2] REITs must derive most of their income from real estate held for the long term; and (3) REITs must be widely held.

In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to expand their business. Instead, capital for growth, capital expenditures and payment of loan principal largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to the smaller investor. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of prop-

[2]From 1960 until 1980, both REITs and regulated investment companies (mutual funds) shared a requirement to distribute at least 90 percent of their taxable income to their shareholders. Although mutual funds continue this 90 percent distribution test, since 1980 REITs have had to distribute 95 percent of their taxable income. To conform to the mutual fund rules once again and to provide more after-tax funds to pay for capital expenditures and debt amortization, NAREIT supports returning the REIT's distribution test to the 90 percent threshold.

erties rather than a single building and expert management by experienced real estate professionals.

Despite the advantages of the REIT structure, the industry experienced very little growth for over 30 years mainly for two reasons. First, at the beginning REITs were handcuffed. REITs were basically passive portfolios of real estate. REITs were permitted only to own real estate, not to operate or manage it. This meant that REITs needed to use third party independent contractors, whose economic interests might diverge from those of the REIT's owners, to operate and manage the properties. This was an arrangement the investment marketplace did not accept warmly.

Second, during these years the real estate investment landscape was colored by tax shelter-oriented characteristics. Through the use of high debt levels and aggressive depreciation schedules, interest and depreciation deductions significantly reduced taxable income—in many cases leading to so-called "paper losses" used to shelter a taxpayer's other income. Since a REIT is geared specifically to create "taxable" income on a regular basis and a REIT is not permitted to pass "losses" through to shareholders like a partnership, the REIT industry could not compete effectively for capital against tax shelters.

In the Tax Reform Act of 1986 (the "1986 Act"), Congress changed the real estate investment landscape. On the one hand, by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses," the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant, going forward, that real estate investment needed to be on a more economic and income-oriented footing.

On the other hand, as part of the 1986 Act, Congress took the handcuffs off REITs. The Act permitted REITs not merely to own, but also to operate and manage most types of income producing commercial properties by providing "customary" services associated with real estate ownership. Finally, for most types of real estate (other than hotels, health care facilities and some other activities that consist of a higher degree of personal services), the economic interests of the REIT's shareholders could be merged with those of the REIT's operators and managers.

Despite Congress' actions in 1986, significant REIT growth did not begin until 1992. One reason was the real estate recession in the early 1990s. During the late 1980s banks and insurance companies kept up real estate lending at a significant pace. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990 the combined impact of the Savings and Loan crisis, the 1986 Act, overbuilding during the 1980s by non-REITs and regulatory pressures on bank and insurance lenders, led to a nationwide depression in the real estate economy. During the early 1990s commercial property values dropped between 30 and 50 percent. Credit and capital for commercial real estate became largely unavailable. As a result of this capital crunch, many building owners defaulted on loans, resulting in huge losses by financial institutions. The Resolution Trust Corporation took over the real estate assets of insolvent financial institutions.

Against this backdrop, starting in 1992, many private real estate companies realized that the best and most efficient way to access capital was from the public marketplace through REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate—assuming recovering real estate markets were just over the horizon. They were right.

Since 1992, the REIT industry has attained impressive growth as new publicly traded REITs infused much needed equity capital into the over-leveraged real estate industry. Today there are over 200 publicly traded REITs with an equity market capitalization exceeding $140 billion. These REITs are owned primarily by individuals, with 49 percent of REIT shares owned directly by individual investors and 37 percent owned by mutual funds, which are owned mostly by individuals. Today's REITs offer smaller real estate investors three important qualities never accessible and available before: liquidity, security and performance.

Liquidity. REITs have helped turn real estate liquid. Through the public REIT marketplace of over 200 real estate companies, investors can buy and sell interests in portfolios of properties and mortgages—as well as the management associated with them—on an instantaneous basis. Illiquidity, the bane of real estate investors, is gone.

Security. Because real estate is a physical asset with a long life during which it has the potential to produce income, investors always have viewed real estate as an investment option with security. But now, through REITs, small investors have an added level of security never available before in real estate investment. Today's security comes from information. Through the advent of the public REIT industry (which is governed by SEC and securities exchange-mandated information disclosure and reporting), the flow of available information about the company and its properties, the management and its business plan, and the property markets and their prospects are available to the public at levels never before imagined. As a result, REIT investors are provided a level of security never available before in the real estate investment marketplace.

Performance. Since their inception, REITs have provided competitive investment performance. Over the past 20 years, REIT market performance has been comparable to that of the Russell 2000 and has exceeded the returns from fixed income and direct real estate investments. Because REITs annually pay out almost all of their taxable income, a significant component of total return on investment reliably comes from dividends. In 1998, REITs paid out almost $11 billion in dividends to their shareholders. Just as Congress intended, today small investors have access through REITs to large-scale, income producing real estate on a basis competitive with large institutions and wealthy individuals.

But REITs certainly do not just benefit investors. The lower debt levels associated with REITs compared to real estate investment overall have a positive effect on the overall economy. Average debt levels for REITs are 35–40 percent of market capitalization, compared to leverage of 80 percent and higher used by privately owned real estate (which has the effect of minimizing income tax liabilities). The higher equity capital cushions REITs from the severe effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs to better withstand market downturns has a stabilizing effect on the real estate industry and lenders, resulting in fewer bankruptcies and work-outs. The general economy benefits from lower real estate losses by federally insured financial institutions.

NAREIT believes the future of the REIT industry will see a continuous and significant shift from private to public ownership of U.S. real estate. At the same time, future growth may be limited by the competitive pressures for REITs to be able to provide more services to their tenants than they are currently allowed to perform. Although the 1986 Act took off the handcuffs and the Taxpayer Relief Act of 1997 included additional helpful REIT reforms, REITs still must operate under certain significant, unnecessary restrictions. NAREIT looks forward to working with Congress and the Administration further to modernize and improve the REIT rules so that REITs can continue to offer smaller investors opportunities for rewarding investments in income-producing real estate.

I. TAXABLE REIT SUBSIDIARIES

As part of the asset diversification tests applied to REITs, a REIT may not own more than 10 percent of the outstanding voting securities of a non-REIT corporation pursuant to section 856 (c)(5)(B).[3] The Administration's Fiscal Year 1999 Budget proposed to amend section 856(c)(5)(B) to prohibit REITs from holding stock possessing more than 10 percent of the vote *or* value of all classes of stock of a non-REIT corporation.[4] Significantly, the Administration's Fiscal Year 2000 Budget proposes an exception to this vote or value rule for taxable REIT subsidiaries.

A. Background and Current Law

The activities of REITs are strictly limited by a number of requirements that are designed to ensure that REITs serve as a vehicle for public investment in real estate. First, a REIT must comply with several income tests. At least 75 percent of the REIT's gross income must be derived from real estate, such as rents from real property, mortgage interest and gains from sales of real property (not including dealer sales).[5] In addition, at least 95 percent of a REIT's gross income must come from the above real estate sources, dividends, interest and sales of securities.[6]

Second, a REIT must satisfy several asset tests. On the last day of each quarter, at least 75 percent of a REIT's assets must be real estate assets, cash and government securities. Real estate assets include interests in real property and mortgages on real property. As mentioned above, the asset diversification rules require that a REIT not own more than 10 percent of the outstanding voting securities of an issuer (other than a qualified REIT subsidiary under section 163(j)). In addition, no more than 5 percent of a REIT's assets can be represented by securities of a single issuer (other than a qualified REIT subsidiary).

[3] The shares of a wholly-owned "qualified REIT subsidiary" ("QRS") of the REIT are ignored for this test.

[4] Since it is a disregarded entity for tax purposes, a qualified REIT subsidiary would be excepted from the requirement that a REIT not own more than 10 percent of the vote or value of another corporation.

[5] I.R.C. § 856(c)(3).

[6] I.R.C. § 856(c)(2).

REITs have been so successful in operating their properties and providing permissible services to their tenants that they have been asked to provide these services to non-tenants, building off of expertise and capabilities associated with the REIT's real estate activities. In addition, mortgage REITs are presented with substantial opportunities to service the mortgages that they securitize. The asset and income tests, however, restrict how REITs can engage in these activities. A REIT can earn only up to 5 percent of its income from sources other than rents, mortgage interest, capital gains, dividends and interest. However, many REITs have had the opportunity to maximize shareholder value by earning more than 5 percent from third party services.

Starting in 1988, the Internal Revenue Service ("IRS") issued private letter rulings to REITs approving a structure to facilitate a REIT providing a limited amount of services to third parties.[7] These rulings sanctioned a structure under which a REIT owns no more than 10 percent of the voting stock and up to 99 percent of the value of a non-REIT corporation through nonvoting stock. Usually, managers or shareholders of the REIT own the voting stock of the "Third Party Subsidiary" ("TPS," also known as a "Preferred Stock Subsidiary"). The TPS typically either provides to unrelated parties services already being delivered to a REIT's tenants, such as landscaping and managing a shopping mall in which the REIT owns a joint venture interest, or engages in other real estate activities, such as development, which the REIT cannot undertake to the same extent. A TPS of a mortgage REIT typically services a pool of securitized mortgages and sells mortgages as part of the securitization process that has the effect of lowering homeowners' interest rates.

See also PLRs 9507007, 9510030, 9640007, 9733011, 9734011, 9801012, 9808011, 9835013.

The REIT receives dividends from the TPS that are treated as qualifying income under the 95 percent income test, but not the 75 percent income test.[8] Accordingly, a REIT continues to be principally devoted to real estate operations. While the IRS has approved using the TPS for services to third parties and "customary" services to tenants the REIT could otherwise provide, the IRS has not permitted the use of these subsidiaries to provide impermissible, non-customary real estate services to REIT tenants.[9]

B. Administration Proposal

In 1998, the Administration proposed changing the asset diversification tests to prevent a REIT from owning securities in a C corporation that represent 10 percent of either the corporation's vote *or* its value. The proposal would have applied with respect to stock acquired on or after the date of first committee action. In addition, to the extent that a REIT's ownership of TPS stock would have been grandfathered by virtue of the effective date, the grandfather status would have terminated if the TPS engaged in a new trade or business or acquired substantial new assets on or after the date of first committee action.

In its Fiscal Year 2000 Budget, the Administration again proposes to base the 10 percent asset test on either vote or value. However, it also proposes an exception for two types of taxable REIT subsidiaries ("TRS"). A qualified business subsidiary ("QBS") would be the successor to the current TPS and could engage in the same activities as can a TPS today. A REIT could not own more than 15 percent of its assets in QBSs. The second type of TRS would be a qualified independent contractor subsidiary ("QIKS"), which could provide non-customary services to the affiliated REIT's tenants. A REIT could not own more than 5 percent of its assets in QIKSs as part of its 15 percent TRS allocation.

A TRS could not deduct any interest payments to its affiliated REIT, and 100% excise tax penalties would be imposed to the extent that any pricing between a TRS and either its affiliated REIT or that REIT's tenants was not set on an arms' length basis. The new TRS rules would apply to all existing TPSs after a time period to be determined by Congress.

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[7] PLRs 9440026, 9436025, 9431005, 9428033, 9340056, 8825112.

[8] The REIT does not qualify for a dividends received deduction with respect to TPS dividends. I.R.C. § 857(b)(2)(A).

[9] *But see* PLR 9804022. In addition, the IRS has been flexible in allowing a TPS to engage in an "independent line of business" in which it provides a service to the public and a minority of the users are REIT tenants. *See*, *e.g.*, PLRs 9627017, 9734011, 9835013.

C. Statement in Support of Taxable REIT Subsidiaries

The REIT industry has grown significantly during the 1990s, from an equity market capitalization under $10 billion to a level approaching $135 billion. The TPS structure is used extensively by today's REITs and has been a small, but important, part of recent industry growth. These subsidiaries help ensure that the small investors who own REITs are able to maximize the return on their capital by taking full economic advantage of core business competencies developed by REITs in owning and operating the REIT's real estate or mortgages. NAREIT appreciates the Administration's recognition that it makes sense to allow a REIT to utilize these core competencies through taxable subsidiaries so long as the REIT remains focused on real estate and the subsidiary's operations are appropriately subject to a corporate level tax.

In addition, the Administration's proposal recognizes that the REIT rules need to be modernized to permit REITs to remain competitive. By virtue of the "customary" standard in defining permissible REIT rental activities, REITs must wait until their competitors have established new levels of service before providing that service to their customers. This "lag effect" assures that REITs are never leaders in their markets, but only followers, to the detriment of their shareholders. Under the Administration proposal, the REIT could render such services to its tenants through a subsidiary that is subject to corporate tax.

The Administration's TRS' proposal is a significant step in the right direction, but NAREIT requests Congress instead to enact the Thomas/Cardin Bill. The Thomas/Cardin closely follows the Administration's subsidiary proposal, but improves and clarifies this concept in four major ways.

First, the Thomas/Cardin Bill would require taxable REIT subsidiaries to fit within the current, unified 25 percent asset test, rather than the unnecessarily complex and cumbersome 5 and 15 percent assets tests under the Administration proposal described above. Requiring two types of TRSs would cause severe complexity and administrative burdens, such as allocating costs between a QBS and a QIKS without incurring a 100% excise tax. Further, the Code should encourage, rather than prohibit, the same TRS providing the same service to its affiliated REIT's tenants and to third parties to make it easier to ensure that the pricing of those services is set at market rates. Moreover, the 5 and 15 percent limits are unnecessarily restrictive given the fact that the subsidiary is subject to a corporate level tax on all of its activities. The Thomas/Cardin Bill adopts the better approach of treating TRS stock as an asset that must fit within the current 25 percent basket of non-real estate assets a REIT can own, along with other non-real estate assets such as personal property.

Second, the Thomas/Cardin Bill would limit interest deductions on debt between a REIT and its taxable REIT subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intra-party interest deductions. Congress confronted very similar earnings stripping concerns in the 1980s with respect to foreign organizations and their U.S. subsidiaries and resolved these concerns by enacting section 163(j). This section permits interest deductions on objective, modest amounts of related party debt. Section 163(j) is easily implemented and guidance has been provided by final regulations. The Thomas/Cardin Bill would adopt even more strict rules for REITs and their subsidiaries by limiting the interest deductions to market rates. Clearly, REITs should not be forced to comply with an absolute denial of legitimate interest deductions when foreign organizations in similar circumstances are not so limited.

Third, the Administration's proposal does not address whether REITs could use a TRS to own or operate hotels. Given Congress' decision in 1998 to curtail the activities of so-called hotel paired share REITs, NAREIT believes it appropriate to ensure that taxable REIT subsidiaries cannot replicate the activities of these entities. The Thomas/Cardin Bill would prohibit a taxable REIT subsidiary from operating or managing hotels, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at a market levels, (b) the rents are not tied to net profits, and (c) the hotel is operated by an independent contractor.

Fourth, the Thomas/Cardin Bill would not apply the new rules on subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects, on a timely basis, taxable REIT subsidiary status for such TPS. Conversely, the Administration proposal would become effective after an undefined period of time. REITs have planned their operations based on IRS rulings starting in 1988 that have sanctioned TPSs and should not be penalized for following established law. The Thomas/

Cardin Bill wisely would adopt the concepts in last year's Administration's effective date that acknowledged the IRS' acquiescence to the TPS structure.

II. CLOSELY HELD REITS

The Administration's Fiscal Year 1999 Budget proposes to add a new rule, creating a limit of 50 percent on the vote or value of stock any entity could own in any REIT.

A. Background and Current Law

As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer individuals cannot own more than 50% of a REIT's stock.[10] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership of the stock by individuals. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders.[11] Both tests do not apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of all taxable years.[12]

The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs doing "step-down preferred" transactions used for various tax planning purposes the Administration finds abusive such as the "liquidating REIT" structure curtailed by the 1998 budget legislation.[13] The Administration proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" (*i.e.*, a corporation, partnership or trust, including a pension or profit sharing trust) from owning stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

B. Statement Providing Limited Support for Administration Proposal on Closely Held REITs

NAREIT shares the Administration's concern that the REIT structure not be used for abusive tax avoidance purposes, and therefore NAREIT concurs as to the intent of the proposal. We are concerned, however, that the Administration proposal casts too broad a net, prohibiting legitimate and necessary use of "closely held" REITs. A limited number of exceptions are necessary to allow certain entities to own a majority of a REIT's stock. NAREIT certainly agrees with the Administration's decision to exclude a REIT's ownership of another REIT's stock from the proposed new ownership limit.[14] NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow legitimate and necessary transactions.

First, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Such an "incubator REIT" sometimes is majority owned by its sponsor to allow the REIT to accumulate a track record that will facilitate its going public. The Administration proposal would prohibit this important approach which, in turn, could curb the emergence of new public REITs in which small investors may invest.

Second, there is no reason why a partnership, mutual fund, pension or profit-sharing trust or other pass-through entity should be counted as one entity in determining whether any "person" owns 50 percent of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity is usually ignored for tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-

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[10] I.RC. § 856(h)(1). There is no apparent reason why the proposed ownership test similarly should not be aimed at limiting *more than* 50 percent stock ownership, rather than 50 percent or more as now proposed.

[11] I.R.C. § 856(a)(5).

[12] I.R.C. § § 542(a)(2) and 856(h)(2).

[13] AREIT supported the Administration's and Congress' move to limit the tax benefits of liquidating REITs.

[14] If the proposed test remains applicable to all persons owning more than 50 percent of a REIT's stock, then Congress should apply the exception for a REIT owning another REIT's stock by examining both direct and indirect ownership so as not to preclude an UPREIT owning more than 50 percent of another REIT's stock.

through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership. Similarly, the Code already has rules preventing a "pension held" REIT from being used to avoid the unrelated business income tax rules,[15] and therefore the new ownership test should not apply to pension or profit-sharing plans. Instead, NAREIT suggests that the new ownership test apply only to non-REIT C corporations that own more than 50 percent of a REIT's stock.[16]

C. SUMMARY

NAREIT supports a change in the REIT rules to prevent the abusive use of closely held REITs, but is concerned that the Administration proposal is overly broad. NAREIT looks forward to working with Congress and the Administration to craft a solution that will prevent such abuses without impeding legitimate and necessary transactions, such as those mentioned above.

III. SECTION 1374

The Administration's Fiscal Year 2000 Budget proposes to amend section 1374 to treat an "S" election by a C corporation valued at $5 million or more as a taxable liquidation of that C corporation followed by a distribution to its shareholders. This proposal also was included in the Administration's Fiscal Year 1997, 1998 and 1999 proposed budgets.

A. BACKGROUND AND CURRENT LAW

Prior to its repeal as part of the Tax Reform Act of 1986, the holding in a court case named *General Utilities* permitted a C corporation to elect S corporation, REIT or mutual fund status (or transfer assets to an S corporation, REIT or mutual fund in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the *General Utilities* doctrine in 1986, such transactions arguably would have been immediately subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election pays any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets only if and when those assets are sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, works to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88–19, 1988–1 C.B. 486 (the "Notice"), the IRS announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of *General Utilities* through the use of REITs and regulated investment companies ("RICs," *i.e.* mutual funds). In addition, the IRS noted that those regulations would enable the REIT or RIC to be subject to rules similar to the principles of section 1374. Thus, a C corporation can elect REIT status and incur a corporate-level tax only if the REIT sells assets in a recognition event during the 10-year "recognition period."

In a release issued February 18, 1998, the Treasury Department announced that it intends to revise Notice 88–19 to conform to the Administration's proposed amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, these comments address the proposed amendment as if it applied to both S corporations and REITs.

B. STATEMENT IN SUPPORT OF THE CURRENT APPLICATION OF SECTION 1374 TO REITS

As stated above, the Administration proposal would limit the use of the 10-year election to REITs valued at $5 million or less. NAREIT believes that this proposal would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely

[15] I.R.C. § 856(h)(3).

[16] As under the current "five or fewer" test, any new ownership test should not apply to a REIT's first taxable year or the first half of subsequent taxable years. *See* I.R.C. §§ 542(a)(2) and 856(h)(2).

would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. 3–4 (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this Congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election is to allow C corporations to make S corporation and REIT elections when those elections are supported by non-tax business reasons (*e.g.*, access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The 100 percent REIT prohibited transactions tax [17] complements the 10-year election mechanism.

Second, while S corporations may have no more than 75 shareholders, a REIT faces no statutory limit on the number of shareholders it may have and is required to have at least 100 shareholders. In fact, some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle primarily to circumvent the repeal of *General Utilities*. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

The consequence of the Administration proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets' infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. In both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owners of such properties. The capital intensive nature of REITs makes the $5 million threshold essentially meaningless for REITs.

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Due to the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make taxable distributions of 95% of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Moreover, the Administration justifies its *de facto* repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its [sic] conversion of a C corporation to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REITs cannot (and have never been able to) pass through losses to their investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs *are* C corporations. Thus, REITs are not susceptible to the tax avoidance concerns raised by the 1986 repeal of the *General Utilities* doctrine.

[17] I.R.C. § 857(b)(6).

We note that on March 9, 1999, the Treasury Department and the IRS released their 1999 Business Plan, in which it listed a project for "[r]egulations regarding conversion of C corporation to [sic] RIC or REIT status." On February 22, 1996, the Treasury Department issued a release stating that "the IRS intends to revise Notice 88–19 to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal." We urge the Congress to use its oversight authority to be certain that the Treasury Department does not enact the "built-in gain" tax on REITs and RICs administratively. Any such action would directly contravene Congress' repeated rejection of any statutory change in this area.

C. SUMMARY

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal's two level tax would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted. Further, the Administration should not contravene the Congress' clear intent in this area by attempting to impose this double level tax on REITs and RICs by administrative means.

Statement of Daniel P. Beard, Senior Vice President, Public Policy, National Audubon Society

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify before you today on the revenue provisions contained in President Clinton's Fiscal Year 2000 Budget. I know it is unusual for the Audubon Society to be providing testimony before the Ways and Means Committee. However, the President's Budget contains a major, new, and exciting environmental initiative, the Better America Bonds that is part of the revenue provisions of the budget.

The Better America Bonds proposal would leverage $700 million dollars in federal tax credits to provide $9.5 billion dollars to finance the purchase of open space, protect water quality, and revitalize brownfields. The Better America Bonds harness the extraordinary power of the tax code for environmental protection including saving vanishing bird and wildlife habitat.

Conservationists applaud the Better America Bonds as an innovative approach to financing environmental protection. The bonds provide the financial incentives to do the right thing, taking a step beyond pure regulatory approaches to environmental problems. The bonds use a relatively small amount of federal tax dollars to leverage billions of dollars of private capital to address urgent environment needs across the nation. Yet, decision-making remains at the local level.

The Better America Bonds proposal comes at a time when the pressures from development and sprawl have never been higher. In virtually every community development is threatening a special place or open space. Every year America loses 2.5 million acres of open space, 100,000 acres of wetlands, and 3 million acres of farmland. Nearly 40% of the nation's waterways are still unsafe for fishing and swimming.

The populations of many bird species continue to decline significantly because of loss of habitat. There are 90 domestic bird species on the endangered species list. The U.S. Fish and Wildlife Service lists another 124 species of migratory nongame birds on their list of migratory nongame birds of management concern.

Mr. Chairman, the Better America Bonds provide communities with a critical tool: the financial ability to compete on a level playing field with developers and other interests. Importantly, these bonds are a flexible tool, they can be tailored to meet the needs of individual communities—your town, any town—from Texas to New York to California.

On behalf of the one million members and supporters of the National Audubon Society, I strongly urge the Committee to support the Better America Bonds. National Audubon Society has included the Better America Bonds in Audubon's Action Agenda for this Congress. With the Better America Bonds, cities and towns are empowered to preserve open space and bird and wildlife habitat for our children to enjoy.

Statement of National Mining Association

The National Mining Association (NMA) appreciates the opportunity to submit this statement for the Committee's record on the President's Fiscal Year 2000 tax proposals. The NMA is an industry association representing most of the Nation's producers of coal, metals, industrial and agricultural minerals. Our membership also includes equipment manufacturing firms and other providers of products and services to the mining industry. The NMA has not received a federal grant, contract or subcontract in Fiscal Years 1999, 1998, 1997, 1996 or 1995.

Mining directly employs over 300,000 workers. Nearly 5 million Americans have jobs as a result of the mining industry's contribution to personal, business and government income throughout the nation. The headquarters of NMA member company operations are located in nearly every state of the Union and some form of mining represented by the NMA occurs in all 50 states.

THE PRESIDENT'S PROPOSAL

Of primary concern to our industry is the Administration's budget proposal to repeal the percentage depletion allowance for minerals mined on federal and former federal lands where mining rights were originally acquired under the Mining Law. The mining industry is adamantly opposed to this proposal. The President included this provision in his 1997,1998 and 1999 budget proposals. It was a bad idea then, it is a worse idea now.

Repeal of the allowance is a major tax increase on companies whose mines are located primarily in the western United States. As it is not uncommon for ownership of mineral deposits to change hands, the proposal would especially penalize mining companies who purchased their properties from original claimants or other intermediary mining concerns.

The U.S. Department of Labor reports that the mining industry provides some of the highest paying nonsupervisory jobs in the United States. The average mining wage in 1996 was $49,995 (not including benefits, overtime and bonuses)—far above the national average wage of $30,053. We believe that tax policy should foster the creation of more of these high-paying jobs. Unfortunately, the Administration's proposal places many of these jobs, principally in economically vulnerable rural areas in the West, at risk.

MINING AND THE MINING LAW

From our perspective, the President's depletion proposal has more to do with mining on public lands in the western states than it does with tax policy. The NMA and its member companies continue to advocate responsible amendments to the Mining Law, including a reasonable royalty provision. This reform effort has been stymied at every turn by anti-mining groups. Those opposing responsible amendments to the Mining Law seek changes that would make mining on public lands nearly impossible. The President's proposal to increase the tax burden on certain hardrock mines would appear to be part of a sustained and coordinated effort to accomplish that goal.

It is a serious misconception to think that minerals mined on federal lands are free for the taking—that mining companies receive something for nothing and are therefore recipients of so-called "corporate welfare." The NMA wishes to set the record straight.

Minerals have no worth if left in the ground undiscovered in the hundreds of millions of acres of unused land controlled by the federal government. They only attain value after they are discovered and produced. And they won't be produced unless there is significant investment and a financial risk shouldered by the mining industry.

The pamphlet prepared by the Joint Committee on Taxation describing the President's fiscal 2000 tax proposals (Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal (JCS–1–99), February 22, 1999) states, in part, that:

> Once a claimed mineral deposit is determined
> to be economically recoverable, and at least
> $500 of development work has been performed,

the claim holder may apply for a "patent" to
obtain full title to the land for $2.50 or
$5.00 per acre.

The Committee should note that considerable funds must be expended in order to demonstrate to the satisfaction of the federal government that the claim contains an "economically recoverable" mineral deposit. It is not uncommon for a mining company to expend several hundred thousands to over a million dollars in conducting exploration activity, performing environmental analyses and gaining the necessary permits prior to being able to demonstrate that the deposit is "economically recoverable" in order to receive a patent under the Mining Law.

The $2.50 or $5.00 per acre fee note in the pamphlet is merely a patent application fee. The costs a mining company must incur to get to the patenting phase usually run in excess of $2,000 per acre, or $40,000 per 20-acre claim. It is impossible to obtain a patent simply by writing a check to the government for $2.50 or $5.00 per acre—a fact conveniently overlooked by mining's critics. Obtaining a patent is an expensive, time-consuming, laborious and by no means guaranteed process.

With or without a patent, a significant amount of capital must then be invested to develop the mine and build the necessary infrastructure to process raw ore into an acceptable product. It is not uncommon to spend in excess of $400 million to bring a domestic world-scale mine into production. The cost of processing facilities is high: A state-of-the-art smelter can have capital costs approaching $1 billion. To argue that minerals are "free for the taking" and mining companies are recipients of so-called corporate welfare is fallacious at best.

THE IMPORTANCE OF THE DOMESTIC MINING INDUSTRY

The President's proposal coupled with other legislative and regulatory initiatives is effectively placing much federally controlled land off-limits to mineral exploration and is making the United States an increasingly hostile business environment for mining investment. As mining companies must continuously search for new reserves or literally mine themselves out of business, this negative environment is increasingly forcing them to look overseas for new exploration projects.

The NMA believes it is in the vital interest of the United States to have a viable domestic mining industry. A study prepared by the Western Economic Analysis Center reports that the domestic mining industry, directly and indirectly, accounts for significant economic activity—$524 billion in 1995 alone. It is beyond a doubt that continued economic growth and improvements in the standard of living for all Americans will depend upon a reliable supply of energy and raw materials. The U.S. mining industry has the potential to provide much of our resource needs—if it is allowed to do so.

IMPACT OF REPEAL

Increasing the tax burden on the mining industry is effectively an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by worldwide supply and demand factors, mining companies cannot recover higher costs by raising prices.

This tax increase is likely to have the following short-and long-term disruptive effects on the industry:

• Reduce the operating lives of many mines by increasing the ore cut-off grade. Minerals that would otherwise have been economic to extract will remain in the ground and not be recovered, resulting in poor stewardship of our natural resources. Existing jobs, federal, state and local tax revenues will be lost.

• Higher taxes will reduce a company's ability to make the necessary investment in existing operations to improve production efficiencies and respond to constantly changing environmental, reclamation, and health and safety standards.

• Investment in new projects will decline. This change to long-standing tax policy will adversely affect the economics of new projects. Many new projects will become uneconomic, resulting in lost opportunities for new jobs and tax revenues.

Clearly, the long-term consequences of this tax increase are serious. Without continuous investment in new domestic projects to replace old mines, mineral production in the United States will decline. We consumed 46,000 pounds of mined materials per person in 1997. The increasing short-fall between the nation's demand for mineral products and domestic supply will then be satisfied by imports of minerals mined by overseas by foreign workers. U. S. exports will become jobs and many areas of the country will experience economic decline and an erosion of state and local tax bases.

Despite the continued overall growth of the economy, the copper and gold metals mining industry (the primary target of the Administration's proposal) has entered into a serious cyclical decline. The price of gold is at its lowest point in 19 years (having declined over 25 percent in the last year) and the price of copper has declined over 40 percent in the past two years. Many mining companies are struggling to remain profitable and keep mines open and miners working to weather this downturn. Indeed, several companies have already implemented mine closures and significant layoffs over the past year.

THE DEPLETION ALLOWANCE

The mining industry is characterized by relative rarity of commercially viable mineral deposits, high economic risks, geologic unknowns, high capital requirements and long lead times for development of new mines. The depletion allowance recognizes the unique nature of mineral extraction by providing a rational and realistic method of measuring the decreasing value of a deposit as minerals are extracted. As the replacement cost of a new mine is always higher in real terms than the mine it replaces, the allowance helps generate the capital needed to bring new mines into production.

THE NEED FOR TAX REDUCTIONS

The mining industry (and other capital-intensive industries) already pay high average tax rates through the application of the corporate alternative minimum tax (AMT). The General Accounting Office in a 1995 study reported that the average effective tax rate for mining companies under the AMT is 32 percent. The AMT gives the United States the worst capital cost recovery system in the industrialized world. Rather than increasing the Tax burden on mining should not be increased, as proposed by the Administration, it should be reduced by reform of the corporate AMT.

CONCLUSION

We urge the Committee and the Congress to reject this job-killing and self-defeating tax increase targeted at the mining industry. Instead, Congress should pass tax legislation designed to foster investment and economic growth in mining and other capital intensive industries and should include reform of the corporate AMT.

Statement of PricewaterhouseCoopers Leasing Coalition

I. INTRODUCTION

On behalf of a group of companies in the leasing industry (hereinafter the "Leasing Coalition"), PricewaterhouseCoopers appreciates the opportunity to present this written statement to the House Ways and Means Committee in conjunction with its March 10, 1999, hearing on the revenue proposals in the Administration's FY 2000 budget.

Our comments center on tax increases proposed by the Administration that would overturn the carefully constructed body of law, built over decades, governing the tax treatment of leasing transactions. These proposals include a leasing-industry specific measure targeting what Treasury refers to as "inappropriate benefits" [1] for lessors of tax-exempt use property. The Leasing Coalition also has strong concerns over the impact on leasing transactions of several general Administration proposals relating to "corporate tax shelters," including a proposal empowering IRS agents to "deny tax benefits" in "tax-avoidance transactions." [2]

In these comments, the Leasing Coalition discusses the rationale underlying the present-law tax treatment of leasing transactions and examines the impact of the Administration's proposals on commonplace leasing arrangements. We also discuss the potentially adverse impact of these proposals on the competitiveness of American businesses, on exports, and on the cost of capital.

We conclude by urging Members of the House Ways and Means Committee to reject the Administration's tax proposals that would adversely affect the leasing in-

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[1] *General Explanations of the Administration's Revenue Proposals*, Department of the Treasury, February 1999, at 113.

[2] *Id*, at 97.

dustry. These proposals inappropriately would overturn the longstanding body of tax law governing common leasing transactions, branding these legitimate business transactions as “corporate tax shelters.” Instead of considering proposals at this time that would impair the competitiveness of the leasing industry, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

II. The Leasing Industry

Leasing is an increasingly common means of financing investment in equipment and other property. In 1998, the U.S. Department of Commerce estimated that approximately 31 percent of all domestic equipment investment was financed through leasing rather than outright acquisition.[3] Approximately 80 percent of U.S. companies lease some or all of their equipment.[4] The leasing industry in 1998 financed more than $180 billion in equipment acquisitions, an amount expected to exceed $200 billion in 1999.

Lessees, or the users of the property, find leasing an attractive financing mechanism for a number of reasons. Because a lease allows 100-percent financing, the lessee is able to preserve cash that would be necessary to buy or make a downpayment on a piece of equipment. Moreover, lessees generally are able to secure financing under a lease at a lower cost than under a loan. A lessee also may wish to use the asset only for a short period of time, and may not want to risk having the value of the equipment decline more quickly than expected—or become obsolete—during this period of use. For financial statement purposes, leasing can be preferable in that it allows the lessee to avoid booking the asset (and the accompanying liability) on its balance sheet. Finally, the lessee may find rental deductions for lease payments more beneficial, from a timing perspective, than depreciation deductions taken over a certain schedule (e.g., double-declining balance).

Leasing also provides a number of business advantages to lessors. Manufacturing companies (e.g., automobile, computer, aircraft, and rolling stock manufacturers) may act as lessors through subsidiary companies as a means of providing their wares to customers. Financial institutions like banks, thrifts, and insurance companies engage in leasing as a core part of their financial intermediation business. As the owner of the equipment, the lessor is able to take full deductions for depreciation. In 1998, between 2,000 and 3,000 companies acted as equipment lessors.

Leasing also promotes exports of U.S. equipment, and thus helps U.S. companies compete in the global economy. Many lease transactions undertaken by U.S. lessors are cross-border leases, i.e., leases of equipment to foreign users. These involve all types of equipment, including tankers, railroad cars, machine tools, computers, copy machines, printing presses, aircraft, mining and oil drilling equipment, and turbines and generators. Many of these leases are supported in one form or another by the Export-Import Bank of the United States, which insures the credit of foreign lessees.

III. Tax Treatment of Leases

A. Present Law

A substantial body of law has developed over the last forty years regarding the treatment of leasing transactions for federal income tax purposes. At issue is whether a transaction structured as a lease is respected as a lease for tax purposes or is recharacterized as a conditional sale of the property. If the transaction is respected as a lease for tax purposes, the lessor is treated as the owner of the property and therefore is entitled to depreciation deductions with respect to the property. The lessor also is entitled to interest deductions with respect to any financing of the property, and recognizes income in the form of the rental payments it receives. The lessee is entitled to a business deduction for the rental payments it makes with respect to the property. On the other hand, if the transaction is recharacterized as a conditional sale, the purported lessee is treated as having purchased the property in exchange for a debt instrument. The purported lessee is treated as the owner of the property and is entitled to depreciation deductions with respect to the property. In addition, the purported lessee is entitled to interest deductions for a portion of the amount it pays under the purported lease. The purported lessor recognizes gain or loss on the conditional sale and recognizes interest income with respect to a por-

[3] U.S. Department of Commerce, Economics and Statistics Administration, Bureau of Economic Analysis.

[4] Equipment Leasing Association.

tion of the amount received under the purported lease. The purported lessor is entitled to interest deductions with respect to any financing of the property.

Guidance regarding the determination whether a transaction is respected as a lease for tax purposes is provided pursuant to an extensive body of case law. There also have been significant IRS pronouncements addressing this determination. Finally, statutory provisions provide specific rules regarding the tax consequences of certain leasing transactions.

1. Case law

The determination whether a transaction is respected as a lease for tax purposes generally is made based on the substance of the transaction and not its form.[5] This substantive determination focuses on which party is the owner of the property that is subject to the lease (i.e., which party has the benefits and burdens of ownership with respect to the property).[6] In addition, the transaction must have economic substance or a business purpose in order to be classified as a lease for tax purposes.[7]

The most important attributes of ownership are the upside potential for economic gain and the downside risk of economic loss based on the residual value of the leased property.[8] The presence of a fair market value purchase option in a lease agreement should not impact the determination of tax ownership.[9] Moreover, the fact that such an option is fixed at the estimated fair market value should not by itself cause the lease to be treated as a conditional sale.[10] However, where a lessee is economically or legally compelled to exercise the purchase option because, for example, the option price is nominal in relation to the value of the property, the lease likely would be treated as a conditional sale.[11]

Another important indicia of ownership for tax purposes is the holding of legal title; this factor, however, is not determinative.[12] The right to possess the property throughout its economic useful life also is an attribute of ownership for tax purposes. For example, the entitlement of the lessee to possession of the property for its entire useful life would be a strong indication that the lessee rather than the lessor should be considered the owner of the property for tax purposes.[13]

The economic substance test finds its genesis in the Supreme Court opinion in *Frank Lyon Co.*, *supra*. There, the United States Supreme Court determined that a sale and leaseback should not be disregarded for federal income tax purposes if the transaction:

> is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . . Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.[14]

The IRS challenged the sale-leaseback transaction in *Frank Lyon* on the grounds that it was a sham. However, the Court concluded that, in the absence of specific facts evidencing a sham transaction motivated solely by tax-avoidance purposes, a lessor need only possess "significant and genuine attributes of traditional lessor status," evidenced by the economic realities of the transaction, in order for a lease to be respected for federal income tax purposes. The Court recognized that there can be many business or economic reasons for entering into a lease. Legal, regulatory, and accounting requirements, for example, can serve as motivations to lease an asset. Instead of trying to identify one controlling factor, the Court used the same test as the other leasing cases—that all facts and circumstances must be considered in determining economic substance. Further, the Court noted that "the fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences."[15]

[5] *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939).
[6] *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985).
[7] *See Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).
[8] *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982), *rev'g*, 76 T.C. 547 (1981).
[9] *Lockhart Leasing Co. v. Commissioner*, 54 T.C. 301, 314–15 (1970), *aff'd* 446 F.2d 269 (10th Cir. 1971).
[10] *See Frank Lyon Co. v. United States*, *supra*.
[11] *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1955), *rev'g*, 12 T.C.M. 277 (1953).
[12] *Coleman v. Commissioner*, 87 T.C. 178, 201 (1986), *aff'd* 883 F.2d 303 (3d Cir. 1987).
[13] *Pacific Gamble Robinson v. Commissioner*, 54 T.C.M. 915 (1987).
[14] *Id.* at 583.
[15] *Id.* at 561.

In the wake of *Frank Lyon*, the Tax Court has refined the analysis of whether a lease should be respected for tax purposes. Under *Rice's Toyota World, Inc. v. Commissioner*, *supra*, and its progeny, the Tax Court will disregard a lease transaction for lack of economic substance only if (i) the taxpayer had no business purpose for entering into the transaction other than to reduce taxes, and (ii) the transaction, viewed objectively, offered no realistic profit potential. Further elaborating on this standard, the Tax Court in *Mukerji v. Commissioner*[16] set forth the test that in subsequent cases has been used to determine whether a lease should be disregarded for tax purposes:

> [u]nder such test, the Court must find "that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction had no economic substance because no reasonable possibility of a profit exists."[17]

Once business purpose is established, a lease transaction should not be classified as a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some economic substance. The Tax Court has developed an objective test for economic substance. A lease will meet the threshold of economic substance and will be respected when the net "reasonably expected" residual value and the net rentals (both net of debt service) will be sufficient to allow taxpayers to recoup their initial equity investment.[18] Applying this analysis, the Tax Court in several cases has concluded that a purported lease transaction was devoid of business purpose and lacked economic substance because the taxpayers could not reasonably expect to recoup their capital from the projected non-tax cash flows in the lease.[19]

Most recently, outside the context of leasing transactions, the Tax Court in *ACM Partnership v. Commissioner*[20] had the opportunity to apply a form of economic substance test. There, the Tax Court stated that "the doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of a transaction that serves no economic purpose other than tax savings."[21] The court further found that the taxpayer could not have hoped to recover its initial investment and its costs under any reasonable economic forecast. This proposition that the economic substance test cannot be satisfied if a taxpayer cannot demonstrate a reasonable expectation of pre-tax profit is consistent with the long-standing body of case law regarding lease transactions.

2. *Administrative pronouncements*

Through revenue rulings and other administrative pronouncements, the IRS has identified certain principles and factors it considers relevant in determining whether a transaction should be treated for tax purposes as a lease or as a conditional sale.

In Rev. Rul. 55–540,[22] the IRS indicated that conditional sale treatment is evidenced where the lessee effectively has the benefits and burdens of ownership for the economic life of the property, as demonstrated by, for example, the application of rentals against the purchase price or otherwise to create an equity interest, the identification of a portion of rentals as interest, the approximate equality of total rentals and the cost of the property plus interest, or the existence of nominal renewal or purchase options. The passage of legal title itself is not determinative.

In addition, the IRS has issued a series of revenue procedures setting forth guidelines that must be satisfied to obtain an advance ruling that a "leveraged lease" (a transaction involving three parties—a lessor, a lessee, and a lender to the lessor) will be respected as a lease for tax purposes.[23] According to Rev. Proc. 75–21, the guidelines set forth therein were published

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[16] 87 T.C. 926 (1986).

[17] *Id.* at 959 (quoting *Rice's Toyota World*, *supra*, at 91).

[18] *See Mukerji*, *supra*.

[19] *See Goldwasser v. Commissioner*, 56 T.C.M. 606 (1988); *Casebeer v. Commissioner*, 54 T.C.M. 1432 (1987); and *James v. Commissioner*, 87 T.C. 905 (1986).

[20] 157 F.3d 231 (3rd Cir. 1998).

[21] *Id.* at 130.

[22] 1955–2 C.B. 39. *See also* Rev. Rul. 55–541, 1955–2 C.B. 19.

[23] *See* Rev. Proc. 75–21, 1975–1 C.B. 715 (setting forth several requirements that must be satisfied for the Service to rule that a transaction is a lease for tax purposes); Rev. Proc. 75–28, 1975–1 C.B. 752 (specifying information that must be submitted pursuant to Rev. Proc. 75–21); Rev. Proc. 76–30, 1976–2 C.B. 647 (providing that the Service will not issue an advance ruling if the property subject to the "lease" is limited use property); Rev. Proc. 79–48, 1979–2 C.B. 529 (modifying Rev. Proc. 75–21 to allow the lessee to pay for certain improvements).

> to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued and thus to provide assistance to taxpayers in preparing ruling requests and to assist the Service in issuing advance ruling letters as promptly as practicable. *These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes* and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances. (*Emphasis added.*)

Thus, the IRS guidelines are intended only to provide a list of criteria that if satisfied ordinarily will entitle a taxpayer to a favorable ruling that a leveraged lease of equipment will be respected as a lease for tax purposes.

With respect to economic substance, the IRS guidelines set forth a profit test that will be met if:

> the aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment [determined without regard to the effect of inflation] exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's equity investment in the property, including any direct costs to finance the equity investment, and the aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.[24]

The IRS guidelines do not specify any particular amount of profit that a lease must generate.[25]

The IRS itself has not relied exclusively on the criteria set forth in the IRS guidelines when analyzing the true lease status of a lease transaction. Moreover, the courts have not treated the IRS guidelines as determinative when analyzing whether a transaction should be respected as a lease for tax purposes.[26] Rather, the IRS guidelines are viewed as constituting a "safe harbor" of sorts. Accordingly, satisfaction of the conservative rule set forth by the applicable IRS guideline with respect to a particular criterion usually is viewed as an indication that the transaction should not be challenged on such a criterion.

3. Statutory provisions

The party that is treated as the owner of the leased asset is entitled to depreciation deductions in respect of such asset. The Deficit Reduction Act of 1984 enacted the "Pickle" rules (named after one of the sponsors of the provision, Representative J.J. Pickle), which restrict the benefits of accelerated depreciation in the case of property leased to a tax-exempt entity.

The Pickle rules generally provide that, in the case of any "tax-exempt use property" subject to a lease, the lessor shall be entitled to depreciate such property using the straight-line method and a recovery period equal to no less than 125 percent of the lease term.[27] Tax-exempt use property, for this purpose, generally is tangible property leased to a tax-exempt entity, which is defined to include any foreign person or entity.[28] In applying the Pickle rules, Treasury regulations adopted in 1996 provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations, which extend beyond the reach of the statutory provision, the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property).[29]

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[24] Rev. Proc. 75–21, *supra*.

[25] The IRS guidelines understate the actual profit earned over the lease term by failing to adjust the residual value of the investment for inflation.

[26] In a footnote in *Frank Lyon*, *supra* at n. 14, the Supreme Court specifically recognized that the IRS guidelines "are not intended to be definitive." Moreover, in *Estate of Thomas v. Commissioner*, 84 T.C. 412, 440 n. 15 (1985), the Tax Court viewed the failure to satisfy all the IRS guidelines as not determinative because the facts and circumstances demonstrated that the transaction satisfied the "spirit" of the guidelines.

[27] I.R.C. section 168(g).

[28] I.R.C. section 168(h).

[29] Treas. Reg. Section 1.168(i)–2(b)(1).

B. ADMINISTRATION'S BUDGET PROPOSALS

The Administration's FY 2000 budget includes several proposals that could have the effect of completely rewriting longstanding tax law on leasing transactions. These proposals, if enacted, would replace the substantial and specific body of law regarding leasing transactions that has developed over the last forty years with broad and largely undefined standards that could be used by IRS revenue agents to challenge traditional leasing transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. Moreover, the proposal to modify the tax rules applicable to cross-border leasing would penalize U.S. lessors and would further hamper the ability of U.S.-based multinationals to compete in the export market.

1. Proposal to deny certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions

The proposal would expand the current-law rules of I.R.C. section 269 to authorize Treasury to disallow any deduction, credit, exclusion, or other allowance obtained in a tax-avoidance transaction.[30] For this purpose, a tax-avoidance transaction would be any transaction in which the present value of the reasonably expected pre-tax profit from the transaction is insignificant relative to the present value of the reasonably expected net tax benefits from the transaction. In addition, the term "tax-avoidance transaction" would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

This proposal creates the entirely new and vague concept of a "tax-avoidance transaction." The first prong of the definition of a tax-avoidance transaction is styled as an objective test requiring a determination of whether the present value of the reasonably expected pre-tax profit from a transaction is insignificant relative to the present value of the reasonably expected net tax benefits from the transaction. However, the inclusion of so many subjective concepts in this equation precludes it from operating as an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test?[31] Next, what are the mechanics for computing pre-tax economic profits and net tax benefits and for determining present values (e.g., what discount rate should be used)? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Moreover, is the determination of "insignificance" transaction-specific; stated otherwise, does the form of the transaction affect the determination of what will be considered "insignificant" for these purposes?

Not only is this prong of the test extremely vague, the uncertainty is compounded by the second prong of the definition of tax-avoidance transaction. Under this alternative formulation, certain transactions involving the improper elimination or significant reduction of tax on economic income would be considered to be tax-avoidance transactions even if they did not otherwise constitute tax-avoidance transactions under the profit/tax benefit test described above. The inclusion of this second prong renders the definition entirely subjective, with virtually no limit on the IRS's discretion to deem a transaction to be a tax-avoidance transaction.

Under this proposal, once the IRS had used its unfettered authority to determine independently that a taxpayer had engaged in a tax-avoidance transaction, the IRS would be entitled to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer in such transaction. Thus, even though a taxpayer's trans-

[30] The "tax-avoidance transaction" concept also is implicated in several other Administration proposals relating to the consequences of corporate tax shelters. Under these proposals, a corporate tax shelter is defined as an arrangement in which a corporate participant obtains a tax benefit in a tax-avoidance transaction. If a corporate tax shelter is found to exist, the Administration proposals would (1) impose a significantly increased substantial understatement penalty, (2) deny deductions for fees for tax advice and impose a 25-percent excise tax on such fees, and (3) impose a 25-percent excise tax on certain rescission provisions or provisions guaranteeing tax benefits. If a transaction is determined to be a tax-avoidance transaction, each of these proposals also potentially would be applicable.

[31] By itself, the determination of the scope of the transaction is both extremely complex and vitally important to the application of this test. Some of the questions to be resolved include: Do the qualified nonrecourse indebtedness rules control the determination of whether debt is considered part of a transaction? If recourse debt is taken into account in defining the transaction, how is the appropriately allocable amount of such debt to be determined? In addition, in defining the transaction, will an implicit charge for the use of capital be taken into account? Will allocations of internal expenses and corporate overhead to the transactions be required? Moreover, will a lease of multiple assets or multiple classes of assets be treated as a single transaction or multiple transactions? All of these questions and more must be answered in order to determine the scope of the transaction, which would be only the starting point in applying this test.

action has economic substance and legitimate business purpose, the IRS would be empowered to deny the tax savings to the taxpayer if another route to achieving the same end result would have resulted in the remittance of more tax. In other words, if an IRS revenue agent believed for any reason that a taxpayer's transaction was too tax efficient, he or she would have the power to strike it down, even if the actual pre-tax return on the transaction satisfied any objective benchmark for appropriate returns. That power could be invoked without regard to the legitimacy of the taxpayer's business purpose for entering into the transaction or the economic substance underlying the transaction.

In the context of leasing transactions, this proposal effectively could wipe out the entire body of law that has developed over the last forty years. A leasing transaction that is scrutinized and passes muster under the benefits and burdens of ownership, business purpose, and economic substance tests could run afoul of this vague new standard. This proposal would completely disregard the presence of a business purpose, ignoring the business reality that lease transactions often are motivated by criteria that would not be taken into account under this new standard. It would replace the traditional economic analysis of lease transactions with this new and largely undefined standard. The long-standing law regarding the treatment of leasing transactions allows taxpayers to employ prudent tax planning to implement business objectives while giving the IRS the tools it needs to address potentially abusive transactions. The extraordinary power that would be vested both in Treasury and in individual IRS revenue agents is unnecessary and would create substantial uncertainty that would frustrate commerce done through traditional leasing transactions.

2. Proposal to preclude taxpayers from taking tax positions inconsistent with the form of their transactions

The proposal generally would provide that a corporate taxpayer could not take any position on a tax return or refund claim that the income tax treatment of a transaction differs from the treatment dictated by the form of the transaction if a "tax-indifferent party" has an interest in the transaction, unless the taxpayer discloses the inconsistent treatment on its original return for the year the transaction is entered into. The form of the transaction would be determined based on all the facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A "tax-indifferent party" would be defined to include foreign persons, native American tribal organizations, tax-exempt organizations, and domestic corporations with expiring loss or credit carryforwards.[32]

This proposal would have a chilling effect on a variety of leasing transactions. For example, the proposal could affect "inbound" lease transactions (i.e., transactions involving a foreign lessor and U.S. lessee), where the transaction takes the form of a lease under foreign law but constitutes a financing for U.S. tax purposes under the body of law described above. The proposal also might be implicated by "outbound" lease transactions (i.e., transactions involving a U.S. lessor and foreign lessee), where the transaction takes the form of a lease for U.S. tax purposes under the body of law described in the preceding section but is treated as a financing under foreign law. If the "form" of the transaction is to be determined for purposes of the proposal by taking into account the foreign law treatment of the transaction, what is the "form" of this transaction? In many cases, the U.S. lessor or lessee does not know and is not able to ascertain the treatment of the transaction under foreign law. In such instances, the U.S. party would have to file some sort of protective disclosure, which would result in a deluge of filings with respect to leasing transactions. Query then whether such disclosure would be of any use to the IRS. This proposal also would have a chilling effect on municipal leases where the city (or other governmental unit) and the lessor treat the lease as a conditional sale for tax purposes. Moreover, the proposal represents a serious departure from the treatment of leasing transactions under present law.

Under well-established law, a taxpayer may disavow the form of a transaction if the taxpayer's actions show an honest and consistent respect for the substance of the transaction. If such consistency exists, the taxpayer can successfully disavow the form of the transaction by introducing "strong proof" that the parties intended the transaction to be something different from its form.[33]

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[32] The "tax-indifferent party" concept also is implicated in a separate Administration proposal that would impose U.S. tax on any income allocable to a tax-indifferent party with respect to a corporate tax shelter.

[33] *Coleman v. Commissioner*, 87 T.C. 178, 201 (1986), *aff'd* 883 F.2d 303 (3d Cir. 1987); *Illinois Power Co. v. Commissioner*, 87 T.C. 1417 (1986). In *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), a case involving a stock purchase agreement,

The IRS recently applied the "strong proof" standard to an inbound Japanese leveraged lease transaction of an aircraft.[34] In determining that the U.S. lessee had met this burden of proof, and thus remained the owner of the aircraft for U.S. tax purposes (despite the fact that the Japanese lessor was considered the owner of such aircraft for Japanese tax purposes), the IRS stated:

> dual tax ownership will not be a concern in the United States when it is solely the result of differing U.S. and foreign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law. Thus, the United States need not be concerned where the taxpayer in a cross-border transaction is able to show that the same facts that led the foreign taxing authorities to conclude that ownership lies in the foreign party, also support the conclusion that the taxpayer is the owner under U.S. standards.

In the context of leasing transactions, the Administration's proposal is unnecessary and is a clear departure from longstanding rules applicable to leasing transactions as expressly sanctioned by the IRS.

3. Proposal to limit "inappropriate" tax benefits for lessors of tax-exempt use property

The proposal would deny recognition of a net loss from a leasing transaction involving tax-exempt use property during the lease term. For this purpose, the leasing transaction would be defined to include the lease itself and all related agreements (i.e., sale, loan, and option agreements) entered into by the lessor with respect to the lease of the tax-exempt use property. Property leased to foreign persons, governments, and tax-exempt organizations would be considered tax-exempt use property.

This proposal would adversely impact a variety of common leasing transactions, including leasing to municipalities and tax-exempt organizations and export leasing. Domestic manufacturers, distributors, and retailers alike avail themselves of export leasing, not only as a pure financing vehicle for major equipment sales, but also as a powerful sales tool to promote equipment sales abroad. Lease financing is attractive to customers for a variety of reasons, including the preservation of cash, possible balance sheet accounting benefits, and a hedge against obsolescence risk. Consider, as an example, a U.S. manufacturer seeking to expand its export sales. That manufacturer's foreign competition is offering lease financing to its customer base. The U.S. manufacturer can compete in the global market only by offering lease financing on comparable terms. This proposal, which would increase the cost of export leasing, hampers the ability of U.S.-based multinationals to compete in the export markets.

This proposal, which affects all deductions and losses with respect to leasing transactions, is much broader than the current Pickle depreciation rules that severely limit depreciation deductions for U.S. lessors that lease to foreign lessees. For example, assume that a U.S. lessor enters into a cross-border lease with a Mexican lessee with the rent stated in pesos. A currency loss due to a devaluation of the peso, realized upon receipt of the peso-denominated rent, might have to be deferred under this proposal. Other types of actual losses could be deferred similarly. In these situations, the proposal would have the effect of denying the current recognition for tax purposes of actual current economic losses.

The only rationale that has been offered for the proposal is Treasury Department concern regarding a narrow class of relatively recent cross-border leasing transactions commonly referred to as "LILO" transactions. As the leasing industry has repeatedly told Treasury, those transactions would be eliminated if the IRS were simply to finalize regulations that it has proposed under section 467. The relevant statutory provision, I.R.C. section 467, was enacted in 1984—15 years ago; the relevant regulations were issued in proposed form in 1996—3 years ago. Yet Treasury and the IRS have chosen not to take the simple step of finalizing the section 467 regulations in order to address these transactions. Indeed, after the release of the FY 2000 budget proposals, which included this proposal, Treasury and the IRS addressed the treatment of LILO transactions through the issuance of Rev. Rul. 99–14, choosing to use the weaker tool available to them—the issuance of a revenue

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the court stated that a taxpayer can challenge the tax consequences of his agreement only through the production of proof which "would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." *Id*. at 775. The court in *Danielson* itself distinguished leasing transactions as a context in which the standard set forth in *Danielson* was not to apply. *See Helvering v. Lazarus*, *supra*; Tech. Adv. Mem. 9307002 (October 5, 1992).

[34] Tech. Adv. Mem. 9802002 (September 18, 1997).

ruling setting forth a litigating position—rather than the stronger weapon in their arsenal—the finalization of regulations that have remained in proposed form for 3 years. The additional tool that this legislative proposal would provide is unnecessary and would be harmful to a significant sector of the economy.

Not only should the Congress reject this proposal, it should consider taking action to help U.S. companies engaged in leasing expand in the global marketplace. In this regard, the leasing industry has repeatedly objected to the Treasury regulations that treat the lease term, for purposes of the Pickle rules, as including periods beyond the actual lease term. The Congress should act to reverse these overreaching regulations. Moreover, the Congress should consider repeal of the Pickle rules themselves.

IV. Impact of Administration's Budget Proposals

A. Impact on Common Transactions

1. Leveraged lease

Consider a standard domestic leveraged lease under which an airline carrier enters into a "sale-leaseback" transaction in order to finance a newly manufactured aircraft. Under this transaction, the airline carrier purchases the aircraft from the aircraft manufacturer and immediately sells it to an institutional investor. The investor finances the acquisition through an equity investment equal to 25 percent of the $100 million purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 75 percent. Immediately after the sale, the investor leases the aircraft to the airline carrier pursuant to a net lease for a term of 24 years. Upon the expiration of the lease term, the aircraft will be returned to the investor (the lessor). During year 18 of the lease, the airline carrier (the lessee) will have an option to purchase the aircraft from the investor for a fixed amount, which will be set at an amount greater than or equal to a current estimate of the then-fair market value of the aircraft. As the tax owner of the aircraft, the lessor is entitled to depreciation deductions in respect of the aircraft and deductions in respect of the interest that accrues on the loan.

The lease in this example complies with applicable case law and with the cash flow and profit tests set forth in Rev. Proc. 75–21. In fact, the sum of the rentals and the expected residual value exceeds the aggregate disbursements of the lessor and the lessor's equity investment, together with applicable costs, by approximately $18 million (or 18 percent of the asset purchase price).

Even though this transaction complies with the established body of leasing law, it appears that it potentially could be characterized as a "tax-avoidance transaction" under the Administration's proposal, discussed above. As noted above, the manner in which the proposal would test whether a transaction is or is not a "tax-avoidance transaction" is capable of numerous different interpretations and appears to be highly subjective. Under a range of potential applications of the proposal to this transaction, it might be determined that the lessor would reasonably expect an annual pre-tax return anywhere in the range of 2.5 percent to 5.5 percent. On an after-tax basis, the lessor might be determined to reasonably expect an annual return anywhere in the range of 6.5 percent to 8.5 percent. Depending on the particular manner in which the proposed test might be applied, the differential between the pre-tax and the after-tax returns could be large enough to suggest that an IRS agent might take the position that the discounted value of the reasonably expected pre-tax profit is not sufficient under the proposed test when compared to the discounted value of the reasonably expected net tax benefits.

Regardless of how the test is applied, however, the tax advantages received by the lessor in this example are identical to the tax benefits that would be received by any owner of the property financing the property in a similar manner and in the same tax bracket. If the tax benefits are disallowed only for lessors, leasing will be put at a disadvantage relative to direct ownership. There is no sensible policy that would declare a leasing transaction to lack economic substance when the identical cash flows and tax benefits would occur for any similarly situated direct owner of such an asset.

2. Export leases

Export leases are another example of a type of commonplace leasing transaction that could be impacted adversely by the Administration's budget proposals. Leaving aside the general question whether these types of leases might be deemed to constitute "tax-avoidance transactions," they would be hit by the separate Administration proposal specifically targeting leasing arrangements involving tax-exempt parties. The proposal, as discussed above, generally would preclude a lessor of tax-exempt use property from recognizing a net loss generated during the lease term by a leasing transaction involving tax-exempt use property.

Consider a commonplace “operating lease” transaction under which a foreign airline carrier seeks to lease a new aircraft from a U.S. manufacturer. The lessor finances the acquisition of such aircraft through an equity investment equal to 20 percent of the purchase price and a loan from a third-party lender equal to the remaining 80 percent. The lessor leases the aircraft to the foreign airline carrier pursuant to an operating lease for a term of 5 years. The rents due thereunder, as well as the expected residual value of the aircraft, are dictated by the market. Upon expiration of the lease term, the aircraft will be returned to the lessor, whereupon the lessor will in all likelihood re-lease the aircraft for additional 5-year periods to other airline carriers. The lessor, as the tax owner of the aircraft, will be entitled to depreciation deductions in respect of the aircraft, using the straight-line method over a term equal to 12 years (i.e., the class life, which is greater than 125 percent of the 5-year lease term), and deductions in respect of the interest that accrues on the loan. For purposes of this example, it is assumed that the lessor will sell the aircraft for its estimated residual value at the end of the second re-lease period in year 15.

The effect of the Administration’s proposal would be to decrease the return to the lessor. The decrease could be large enough that the U.S. lessor could not offer attractive aircraft financing, surrendering this business opportunity to a foreign lessor and manufacturer. Under current law, the lessor would be able to achieve an after-tax yield of approximately 6.7 percent. That return is based, in part, on the rents due under the lease (and the re-lease) and the residual value of the aircraft upon the expiration of the re-lease (in each case, net of any debt service), and, in part, on the net tax benefits available to such lessor. If, as would be required under the Administration’s proposal, the net tax losses available to the lessor in the early years had to be carried forward to offset the taxable income generated by such lease in the later years, the after-tax yield of the lessor (holding all other variables constant) would drop to approximately 6.1 percent.

Or, consider a transaction under which a foreign airline carrier seeks to finance a new aircraft produced by a U.S. manufacturer on a long-term basis. The foreign airline carrier purchases the aircraft from the U.S. manufacturer and immediately sells it to a U.S. institutional investor. The investor finances the acquisition through an equity investment equal to 13 percent of the purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 87 percent. Immediately after the sale, the investor leases the aircraft to the foreign airline carrier pursuant to a net lease for a term of 24 years. Upon expiration of the lease term, the aircraft will be returned to the investor (the lessor). At the end of year 18.5 of the lease, the foreign airline carrier (the lessee) will have the option to purchase the aircraft for a fixed amount, which will be set at an amount equal to or greater than a current estimate of the then-fair market value of the aircraft. The investor, as the tax owner of the aircraft, will be entitled to depreciation deductions in respect of the aircraft, using the straight-line method over a term that is at least equal to 125 percent of the lease term, and deductions in respect of the interest that accrues on the loan. In the early years of the lease term, the depreciation deductions and interest expense deductions exceed the amounts paid by the lessee to the lessor. The lease in this example complies with applicable case law and with the cash flow and profits tests set forth in Rev. Proc. 75–21.

The effect of the Administration’s tax-exempt use property proposal would be to increase the cost of financing this transaction. Under current law, the investor in this example is able to offer the lessee financing at a rate that would equate to the airline borrowing at about a 7.1-percent interest rate—a lower rate than the lessee could hope to achieve if it financed the acquisition through a loan. This lower cost of capital is due to the tax deferral created when the lessor takes depreciation and interest deductions in the early years of the lease, amounting to net losses, and recognizes income in the later years. Carrying forward these net losses to offset taxable income generated by the lease, as the Administration proposal would require, would increase the 7.1.-percent effective interest rate in this example by *40 basis points*, to 7.5 percent. Taking into account the dollar size of these transactions (with typical deals in the hundreds of millions of dollars), a 40 basis point shift would render this U.S. manufacturer/lessor’s financing uncompetitive in the global markets.

B. Impact on Competitiveness

The ability of U.S. equipment manufacturers to compete in global markets may depend in part on their ability to arrange financing terms for their potential customers that are competitive with those that can be arranged by foreign producers.

The Administration's budget proposals would make it much more difficult and potentially impossible to arrange financing on competitive terms.

For example, consider the case of a U.S. aircraft manufacturer seeking to expand into the European market.[35] A European airline may find price to be a final determining factor in comparing an aircraft manufactured by a U.S. company with one produced by a European manufacturer. Financing provisions, such as lease terms, directly influence the cost. The U.S. manufacturer's ability to sell its aircraft to the European airline may be contingent on its ability to assist the airline with arranging a suitable lease that is competitive with the lease terms that can be offered with respect to the European aircraft.

As shown in the examples above (see section IV. A), a U.S. aircraft manufacturer might be able to offer a European airline a short-term operating lease or a long-term financial lease, taking into account current U.S. tax law, at a rate that would be attractive to the foreign airline. In the financial lease, the airline effectively would borrow at a 7.1-percent interest rate. The European aircraft manufacturer, if it worked through a German investor, might be able to offer financing to the airline at a much lower rate, potentially as low as 5.5 percent.[36] A chief reason for this disparity is the favorable tax treatment of leased property under German law, including significantly accelerated depreciation for the lessor even when the lessee is a tax-exempt entity under German tax law. Under the present Pickle rules, a U.S. export lease on U.S. equipment cannot compete with a German lease on similar German equipment. The availability of favorable lease rules in foreign jurisdictions, such as the German rules, already hinders the ability of U.S. companies to compete in the global market. Changes to the rules further impairing the tax treatment of export leasing will further disadvantage U.S. leasing companies and U.S. manufacturers vis-a-vis their foreign counterparts.

If enacted, the Administration's budget proposals would tilt the balance in these competitive financing situations even further against the U.S. manufacturer. For leasing-intensive industries, the proposals could make it prohibitive to expand in existing markets or to enter into emerging markets on a competitive basis.

The Administration's proposals also would impede the ability of U.S.-based financial institutions to compete in the worldwide leasing market. If enacted, the Administration's proposals would give foreign-based financial institutions a leg up in providing financing. The impact of these proposals on the U.S. financial sector, an important part the U.S. economy, should not be overlooked.

C. Impact on Exports

Because the Administration's proposals effectively would make U.S.-manufactured goods in leasing-intensive industries more expensive in foreign markets, these measures could be expected to have an adverse effect on American exports.

A significant percentage of American exports is attributable to leasing. While no exact data regarding this percentage is available, consider that data discussed in section II, above, indicated that nearly one third of all equipment investment, at least on a domestic basis, is financed through leasing. Further, consider that exports of equipment in 1997 represented 43 percent of all goods exported by the United States.[37] Moreover, the share of exported goods accounted for by equipment has been rising steadily since 1980. Despite the strong showing of U.S. exported equipment, we live in a highly competitive world and face worldwide competition in our export markets and at home for these products.

In certain sectors most likely to be leasing-intensive, exports are accountable for a substantial share of domestic production. For example, exports account for 50 percent of U.S. production of aircraft, aircraft engines, and other aircraft parts; 28 percent of U.S. production of construction equipment; 31 percent of U.S. production of farm machinery; 40 percent of U.S. production of machine tools; and 56 percent of U.S. production of mining machinery. In the absence of these exports, domestic employment in these equipment-producing industries would be substantially reduced.

D. Impact on Start-Ups, Companies in Economic Downturn

Some companies that directly own their assets may find that they have a higher cost of capital than their competitors due to special tax circumstances. For example, companies in a loss position (as is the case for many businesses in the start-up phase) and companies paying AMT (which often hits companies experiencing eco-

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[35] About half of the aircraft flown in Europe are leased rather than owned by airlines.
[36] Using similar assumptions and terms as under the example in section IV.A.
[37] Department of Commerce, Bureau of Economic Analysis.

nomic downturns) often have a higher cost of capital because they cannot immediately claim all of the depreciation allowances provided under the tax law. These companies may be at a competitive disadvantage relative to other firms. Some regard it as unfair that a company in the start-up phase or recovering from an economic downturn faces higher costs for new investment than its competitors.

Through leasing, a company in these circumstances often can achieve a cost of capital comparable to that of its competitors. Leasing helps to "level the playing field" between companies in an adverse tax situation and their competitors by equalizing the cost of capital. For certain assets, leasing can lower the cost of capital for a firm in this tax situation by as much as one percentage point. This can mean the difference between successfully competing and bankruptcy. Rehabilitation or liquidation in bankruptcy can be more detrimental to U.S. revenues than the granting of ordinary depreciation and interest deductions.

By denying the benefits of leasing, the Administration's proposals would further increase the cost of capital for companies in such circumstances. As a result, the economy suffers real losses. Investment may be allocated not on the basis of who is the most efficient or productive producer, but who is in the most favorable tax situation. In the absence of leasing, a company in a loss position—facing a higher cost of capital than its competitors—might not be able to undertake new investment even if, in the absence of taxes, it would be the most efficient firm.

V. Conclusion

The Leasing Coalition urges Members of the House Ways and Means Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. As discussed above, we believe these proposals inappropriately would overturn the longstanding and carefully crafted body of tax law governing common leasing transactions and would have a deleterious impact on the U.S. economy. Moreover, we find it highly objectionable that these common and legitimate business transactions effectively are being cast by the Administration as "corporate tax shelters." Instead of considering proposals at this time that would impair the competitiveness of the leasing industry and industries that manufacture goods commonly acquired through lease arrangements, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

Statement of Judy Carter, Chief Executive Officer and President, Softworks, Alexandria, Virginia; and R&D Credit Coalition

Mr. Chairman and members of the committee, my name is Judy Carter, and I am the Chief Executive Officer and President of Softworks of Alexandria, Virginia. I thank you for the opportunity to submit this statement on behalf of the R&D Credit Coalition on the importance of making permanent the research and experimentation tax credit (commonly referred to as the "R&D" credit). The R&D Credit Coalition is a broad-based coalition of 53 trade associations and approximately 1,000 small, medium and large companies, all united in seeking the permanent extension of the R&D credit. The members of the R&D Credit Coalition represent many of the most dynamic and fastest growing companies in the nation and include the entire spectrum of technology, manufacturing, pharmaceuticals and software.

Softworks has been in the information technology business for 21 years—during this time we have both contributed to and benefited from the evolution of information and computing technology. We are a global company with software solutions that are sold in every major market around the world. We have offices in the UK, France, Italy, Spain, Germany, Japan, Australia and Brazil, as well as thirteen offices throughout the U.S. and Canada. We have over 2000 customers worldwide including 82 of the Fortune 100 companies and about 42% of the Fortune 500. Importantly, we currently employ over two hundred workers in the United States.

I want to commend Representatives Nancy Johnson and Bob Matsui, and the original cosponsors of H.R. 835, and Senators Hatch and Baucus, and the original cosponsors of S. 680, for introducing legislation to permanently extend the R&D credit and to provide a modest 1% increase in the Alternative Incremental Research Credit ("AIRC") rates. I also want to commend President Clinton for including, and funding, an extension of the R&D tax credit in the Administration's FY 2000 Budget.

As the Committee members consider tax legislative options in the 106th Congress, the Coalition encourages them to implement fiscal policies and initiatives that will fuel the U.S. economy, keeping American companies and their workers prosperous and competitive in the changing global marketplace as we enter the 21st century. Without a growing economy, Americans' standard of living, and our ability to support the needs of our aging population, will be in jeopardy. Faced with a static or decreasing workforce as U.S. demographics shift, U.S. lawmakers must focus on encouraging technology development to increase productivity, enabling a smaller workforce to support a growing population of retirees. Increased technology development will help to ensure sustained economic growth and the prosperous environment needed to continue to improve our standard of living for current and future generations of Americans, will permit additional individual tax reductions, and will ensure a growing economy with resources necessary to adequately support the health and retirement needs of an aging U.S. population. The R&D tax credit, according to many government and private sector experts, is a proven, effective means of generating increased research and development activity, which in turn will provide effective means of generating increased research and development activity, which in turn will provide the technology improvements to benefit the economy.

Last year the accounting firm of Coopers & Lybrand (now Pricewaterhouse-Coopers) completed a new study, *Economic Benefits of the R&D Tax Credit*, (January, 1998) that dramatically illustrates the significant economic benefits provided by the credit, and further reinforces the need to make the credit permanent. According to the study, making the R&D credit permanent would stimulate substantial amounts of additional R&D, increase national productivity and economic growth almost immediately, and provide U.S. workers with higher wages and after-tax income. I hope the Congress will take swift action to permanently extend the R&D credit by enacting the provisions of H.R. 835—S. 680 before the credit expires once again on June 30, 1999.

I. R&D CREDIT LEGISLATIVE HISTORY

The R&D credit was enacted in 1981 to provide an incentive for companies to increase their U.S. R&D activities. As originally passed, the R&D credit was to expire at the end of 1985. Recognizing the importance and effectiveness of the provisions, Congress decided to extend it. In fact, since 1981 the credit has been extended nine times. In addition, the credit's focus has been sharpened by limiting both qualifying activities and eligible expenditures. With each extension, the Congress indicated its strong bipartisan support for the R&D credit.

In 1986, the credit lapsed, but was retroactively extended and the rate cut from 25 percent to 20 percent. In 1988, the credit was extended for one year. However, the credit's effectiveness was further reduced by decreasing the deduction for R&D expenditures by 50% of the credit. In 1989, Congress extended the credit for another year and made changes that were intended to increase the incentive effect for established as well as start-up companies. In the 1990 Budget Reconciliation Act, the credit was extended again for 15 months through the end of 1991. The credit was again extended through June 30, 1992, by the Tax Extension Act of 1991. In OBRA 1993, the credit was retroactively extended through June 30, 1995.

In 1996, as part of the Small Business Job Protection Act of 1996, the credit was extended for eleven months, through May 31, 1997, but was not extended to provide continuity over the period July 1, 1995 to June 30, 1996. This one-year period, July 1, 1995 to June 30, 1996, was the first gap in the credit's availability since its enactment in 1981.

In 1996, the elective Alternative Incremental Research Credit ("AIRC") was added to the credit, increasing its flexibility and making the credit available to R&D intensive industries which could not qualify for the credit under the regular criteria. The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns which are a normal part of a company's life cycle. The sponsors of H.R. 835 and S. 680 recognize the importance of the AIRC. Their legislation, in addition to making the credit permanent, provides for a modest increase in the AIRC rates that will bring the AIRC's incentive effect more into line with the incentive provided by the regular credit to other research-intensive companies.

The Congress next approved a thirteen month extension of the R&D credit that was enacted into law as part of the Taxpayer Relief Act of 1997. The credit was made available for expenditures incurred from June 1, 1997 through June 30, 1998, with no gap between this and the previous extension. Most recently, the Congress approved a one year extension of the credit, until June 30, 1999.

According to the Tax Reform Act of 1986, the R&D credit was originally limited to a five-year term in order "to enable the Congress to evaluate the operation of the credit." While it is understandable that the Congress in 1981 would want to adopt this new credit on a trial basis, the credit has long since proven over the sixteen years of its existence to be an excellent highly leveraged investment of government resources to provide an effective incentive for companies to increase their U.S.-based R&D.

The historical pattern of temporarily extending the credit, combined with the first gap in the credit's availability, reduces the incentive effect of the credit. The U.S. research community needs a stable, consistent R&D credit in order to maximize its incentive value and its contribution to the nation's economic growth and sustain the basis for ongoing technology competitiveness in the global arena.

II. WHY DO WE NEED A R&D CREDIT?

A. The credit offsets the tendency for under investment in R&D

The single biggest factor driving productivity growth is innovation. As stated by the Office of Technology Assessment in 1995: "Much of the growth in national productivity ultimately derives from research and development conducted in private industry." Sixty-six to eighty percent of productivity growth since the Great Depression is attributable to innovation. In an industrialized society R&D is the primary means by which technological innovation is generated.

Companies cannot capture fully the rewards of their innovations because they cannot control the indirect benefits of their technology on the economy. As a result, the rate of return to society from innovation is twice that which accrues to the individual company. This situation is aggravated by the high risk associated with R&D expenditures. As many as eighty percent of such projects are believed to be economic failures.

Therefore, economists and technicians who have studied the issue are nearly unanimous that the government should intervene to increase R&D investment. The most recent study, conducted by the Tax Policy Economics Group of Coopers & Lybrand, concluded that "...absent the R&D credit, the marketplace, which normally dictates the correct allocation of resources among different economic activities, would fail to capture the extensive spillover benefits of R&D spending that raise productivity, lower prices, and improve international trade for all sectors of the economy." Stimulating private sector R&D is particularly critical in light of the decline in government funded R&D over the years. Direct government R&D funding has declined from 57% to 36% of total R&D spending in the U.S. from 1970 to 1994. Over this same period, the private sector has become the dominant source of R&D funding, increasing from 40% to 60%.

B. The credit helps U.S. business remain competitive in a world marketplace

The R&D credit has played a significant role in placing American businesses ahead of their international competition in developing and marketing new products. It has assisted in the development of new and innovative products; providing technological advancement, more and better U.S. jobs, and increased domestic productivity and economic growth. This is increasingly true in our knowledge and information-driven world marketplace.

Research and development must meet the pace of competition. In many instances, the life cycle of new products is continually shrinking. As a result, the pressure of getting new products to market is intense. Without robust R&D incentives encouraging these efforts, the ability to compete in world markets is diminished.

Continued private sector R&D is critical to the technological innovation and productivity advances that will maintain U.S. leadership in the world marketplace. Since 1981, when the credit was first adopted, there have been dramatic gains in R&D spending. Unfortunately, our nation's private sector investment in R&D (as a percentage of GDP) lags far below many of our major foreign competitors. For example, U.S. firms spend (as a percentage of GDP) only one-third as much as their German counterparts on R&D, and only about two-thirds as much as Japanese firms. This trend must not be allowed to continue if our nation is to remain competitive in the world marketplace.

Moreover, we can no longer assume that American companies will automatically choose to site their R&D functions in the United States. Foreign governments are competing aggressively for U.S. research investments by offering substantial tax and other financial incentives. Even without these tax incentives, the cost of performing R&D in many foreign jurisdictions is lower than the cost to perform equivalent R&D in the U.S.

An OECD survey of sixteen member countries found that thirteen offer R&D tax incentives. Of the sixteen OECD nations surveyed, twelve provide a R&D tax credit or allow a deduction for more than 100% of R&D expenses. Six OECD nations provide accelerated depreciation for R&D capital. According to the OECD survey, the

U.S. R&D tax credit as a percentage of industry-funded R&D was *third lowest* among nine countries analyzed.

Making the U.S. R&D tax credit permanent, however, would markedly improve U.S. competitiveness in world markets. The 1998 Coopers & Lybrand study found that, with a permanent credit, annual exports of goods manufactured here would increase by more than $6 billion, and imports of good manufactured elsewhere would decrease by nearly $3 billion. Congress and the Administration must make a strong and permanent commitment to attracting and retaining R&D investment in the United States. The best way to do that is to permanently extend the R&D credit.

C. THE CREDIT PROVIDES A TARGETED INCENTIVE FOR ADDITIONAL R&D INVESTMENT, INCREASING THE AMOUNT OF CAPITAL AVAILABLE FOR INNOVATIVE AND RISKY VENTURES

The R&D credit reduces the cost of capital for businesses that increase their R&D spending, thus increasing capital available for risky research ventures.

Products resulting from R&D must be evaluated for their financial viability. Market factors are providing increasing incentives for controlling the costs of business, including R&D. Based on the cost of R&D, the threshold for acceptable risk either rises or falls. When the cost of R&D is reduced, the private sector is likely to perform more of it. In most situations, the greater the scope of R&D activities, or risk, the greater the potential for return to investors, employees and society at large.

The R&D credit is a vital tool to keep U.S. industry competitive because it frees-up capital to invest in leading edge technology and innovation. It makes available additional financial resources to companies seeking to accelerate research efforts. It lowers the economic risk to companies seeking to initiate new research, which will potentially lead to enhanced productivity and overall economic growth.

D. PRIVATE INDUSTRIAL R&D SPENDING IS VERY RESPONSIVE TO THE R&D CREDIT, MAKING THE CREDIT A COST EFFECTIVE TOOL TO ENCOURAGE ECONOMIC GROWTH

Economic studies of the credit, including the Coopers & Lybrand 1998 study, the KPMG Peat Marwick 1994 study, and the article by B. Hall entitled: "R&D Tax Policy in the 1980s: Success or Failure?" *Tax Policy and the Economy* (1993), have found that a one-dollar reduction in the after-tax price of R&D stimulates approximately one dollar of additional private R&D spending in the short-run, and about two dollars of additional R&D in the long run. The Coopers & Lybrand study predicts that a permanent R&D credit would lead U.S. companies to spend $41 billion more (1998 dollars) on R&D for the period 1998–2010 than they would in the absence of the credit. This increase in private U.S. R&D spending, the 1998 study found, would produce substantial and tangible benefits to the U.S. economy.

Coopers & Lybrand estimated that this permanent extension would create nearly $58 billion of economic growth over the same 1998–2010 period, including $33 billion of additional domestic consumption and $12 billion of additional business investment. These benefits, the 1998 study found, stemmed from substantial productivity increases that could add more than $13 billion per year of increased productive capacity to the U.S. economy. Enacting a permanent R&D credit would lead U.S. companies to perform significantly more R&D, substantially increase U.S. workers' productivity, and dramatically grow the domestic economy.

E. RESEARCH AND DEVELOPMENT IS ABOUT JOBS AND PEOPLE

Investment in R&D is ultimately an investment in people, their education, their jobs, their economic security, and their standard of living. Dollars spent on R&D are primarily spent on salaries for engineers, researchers and technicians.

When taken to market as new products, incentives that support R&D translate to salaries of employees in manufacturing, administration and sales. Of exceptional importance to Softworks and the other members of the R&D Credit Coalition, R&D success also means salaries to the people in our distribution channels who bring our products to our customers as well as service providers and developers of complementary products. And, our customers ultimately drive the entire process by the value they put on the benefit to them of advances in technology (benefits that often translate into improving their ability to compete). By making other industries more competitive, research within one industry contributes to preserving and creating jobs across the entire economy.

My experience has been that more than 75 percent of expenses qualifying for the R&D credit go to salaries for researchers and technicians, providing high-skilled, high-wage jobs to U.S. workers. Investment in R&D, in people working to develop new ideas, is one of the most effective strategies for U.S. economic growth and competitive vitality. Indeed, the 1998 Coopers & Lybrand study shows improved worker productivity throughout the economy and the resulting wage gains going to hi-tech and low-tech workers alike. U.S. workers' personal income over the 1998–2010 period, the 1998 study predicts, would increase by more than $61 billion if the credit were permanently extended.

F. The R&D credit is a market driven incentive

The R&D credit is a meaningful, market-driven tool to encourage private sector investment in research and development expenditures. Any taxpayer that increases their R&D spending and meets the technical requirements provided in the law can qualify for the credit. Instead of relying on government-directed and controlled R&D spending, businesses of all sizes, and in all industries, can best determine what types of products and technology to invest in so that they can ensure their competitiveness in the world marketplace.

III. THE R&D CREDIT SHOULD BE MADE PERMANENT TO HAVE MAXIMUM INCENTIVE EFFECT

As the Joint Committee on Taxation points out in the Description of Revenue Provisions in the President's Fiscal Year 2000 Budget Proposal (JCS–1–99), "If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure." Research projects cannot be turned off and on like a light switch; if corporate managers are going to take the benefits of the R&D credit into account in planning future research projects, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and extended gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital.

In order to increase their R&D efforts, businesses must search for, hire, and train scientists, engineers and support staff. They must often invest in new physical plants and equipment. There is little doubt that a portion of the incentive effect of the credit has been lost over the past seventeen years as a result of the constant uncertainty over the continued availability of the credit.

If the credit is to provide its maximum potential for increased R&D activity, the practice of periodically extending the credit for short periods, and then allowing it to lapse, must be eliminated, and the credit must be made permanent. Only then will the full potential of its incentive effect be felt across all the sectors of our economy.

IV. CONCLUSION

Making the existing R&D credit permanent best serves the country's long term economic interests as it will eliminate the uncertainty over the credit's future and allow R&D performing businesses to make important long-term business decisions regarding research spending and investment. Private sector R&D stimulates investment in innovative products and processes that greatly contribute to overall economic growth, increased productivity, new and better U.S. jobs, and higher standards of living in the United States. Moreover, by creating an environment favorable to private sector R&D investment, jobs will remain in the United States. Investment in R&D is an investment in people. A permanent R&D credit is essential for the United States economy in order for its industries to compete globally, as international competitors have chosen to offer direct financial subsidies and reduced capital cost incentives to "key" industries. The R&D Credit Coalition strongly supports the permanent extension of the R&D credit, and increasing the AIRC rates by 1%, and urges Congress to enact the provisions of H.R. 835—S. 680 before the credit expires on June 30, 1999.

Statement of Hon. Bernie Sanders, a Representative in Congress from the State of Vermont

Mr. Chairman, thank you for holding this hearing and providing me with the opportunity to express my concerns regarding the Clinton Administration's FY2000 revenue proposal. Among the many suggestions is a change in the way Employee Stock Ownership Plans are taxed. This is a vitally important issue that impacts many communities throughout the country, especially in my home state of Vermont.

Employee Stock Ownership Plans (ESOPs) play a vital role in our changing economy. Presently, over 11,100 ESOPs operate within the United States whose net worth exceeds 400 billion dollars. Unlike most corporations, employees own a piece of these companies, and their success. Today, there are more than 7.7 million employee-owners in America, encouraging employment stability, job creation, and subsequent long-term economic growth.

ESOPs provide an incentive for employees to work hard and work together to make their business more effective. They encourage job creation and facilities investment, which are at the bedrock of healthy long-term economic growth. Employee-ownership fosters a culture of cooperation and a real and lasting connection to a company. The company benefits because the employees work harder. The employee benefits by building long-term wealth and retirement security. Employee ownership is good for employees and good for the country. Congress should act to promote employee ownership rather than implement measures that would make it more difficult.

ESOPs promote economic prosperity as well as basic democratic values in America. We live and work in an economy that is characterized by concentration, a trend that tends to place enormous distance between the people who make decisions and the people who work for companies. The choices that make the best sense to those in control—downsizing, maximization of short-term profits, and sending jobs overseas—are not always the decisions that are in the best interests of American workers.

Everyone stands to gain from employee-owned ventures. Working people gain a stake in the company and control over their workplace. In turn, the company stands to profit because workers have greater incentive to streamline operations and increase output. By affording employees a real stake in the success of the business, companies prosper. Yet perhaps more importantly, employee-ownership builds a better, more equitable America where people have control over the economic fate of their households and their communities.

Employee-ownership fosters a different set of priorities which focuses on the promotion of the worker, the company and the community in which the ESOP is located. Instead of maximizing short term profit, employee owners concentrate on the long-term health of their company and their community. In addition to the development of new techniques to improve production, employee-ownership affords workers the chance to enjoy a long term career with one company. In an era of down-sizing and part-time work, the advantages of long-term employment with one company, such as health care and decent retirement, are quickly things of the past. As the income gap continues to widen, employee-ownership builds long term prosperity for middle-class and working Americans by encouraging job creation and stability as well as practices that sustain local economies and their communities.

I want to tell you a little about a company from my district—King Arthur Flour in Norwich, Vermont. King Arthur, the oldest flour company in the United States, turned into an ESOP in 1996. Right now they earn $21 million dollars a year in sales, employing 110 people.

And what does King Arthur's prosperity have to do with worker ownership? A lot, if you ask the people from King Arthur. The spirit of employer-ownership has taken root there, making the company more efficient and profitable. And King Arthur is able to provide many of its' employee-owners something that is becoming rare it our economy—good-paying jobs that have decent benefits and provide for a comfortable retirement. But don't take my word—let me give you some examples of how employee-ownership has made this difference.

When the people working in the warehouse realized that there was a connection between the number of boxes they packed and the size of their stock allocation at the end of the year, they decided to act. They worked out ways to do their jobs more efficiently and between 1994 and 1997 the King Arthur warehouse team increased its boxes per work-hour from 13 to 25 with no new technology, no loss of safety, and no increase in product damage. That is an amazing increase in just three years.

Another example of can be found in the catalogue operations at King Arthur. Employees sat down and figured out how much each returned product cost the company. Working together with several departments, King Arthur has lowered the return rate to just 2 percent, an incredible accomplishment.

I come before the committee today to express serious concerns regarding the Administrations FY2000 Revenue proposal. Amid the many suggestions is one to change the way in which Employee Stock Ownership Plans are taxed. The Clinton Administration has proposed eliminating the special exemption from "UBIT" (unrelated business income tax) for ESOPs in S corporations.

The Administration views this exemption as a violation of the general principle that business income should be taxed when it is earned. They are concerned that not doing so allows significant deferral, and avoidance, of tax on S corporation income that is owned by an ESOP. The Administration would like to tax these ESOP owned corporation like any other, then offer a deduction for profit paid out to employee-owners.

This proposal bothers me for two reasons. This rule was developed to provide a tax incentive to encourage the establishment and success of ESOPs. The Administration fails to explain why the principle of taxing income when it is earned is more important than the encouragement of ESOPs. The proposal would offer some tax advantage to ESOPs, but a lesser, and importantly, more complicated one.

I am aware that some tax consultants have been attempting to take advantage of this tax opportunity in a way that Congress did not intend. I would urge the members of the Committee to close this opportunity to those for whom it was not intended, but I strongly feel that it should be preserved for legitimate ESOPs. Abuse by some tax consultants is no justification for the elimination of this important provision for ESOPs.

Statement of Securities Industry Association

I. *Introduction*

The Securities Industry Association ("SIA") appreciates the opportunity to submit written testimony to the Committee on Ways and Means regarding the revenue-raising proposals in the Administration's FY 2000 budget which deal with financial instruments and transactions. SIA brings together the shared interests of more than 740 securities firms. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals.

We are concerned about the effects that the revenue proposals in the Administration's fiscal year 2000 budget that are discussed below would have on the functioning of capital markets if they were enacted. Our comments are both technical and practical, and we draw upon our substantial experience in helping businesses raise capital and reorganize ownership structures to meet business needs, as well as in standing ready to both buy and sell stocks, securities, and derivative products in order to accommodate the free flow of capital to its most productive uses.

In broad summary of what is set out below, we think these proposals have the following flaws: First, they are founded on notions of economic equivalence that are factually inaccurate and in any case inconsistent with current tax policy and practice. Second, their adoption would needlessly impede the free flow of capital and the functioning of capital markets. Third, their adoption would effectively increase the tax on investment capital—particularly the corporate-level tax—thereby discouraging savings and investment. We note that the U.S. already imposes one of the world's highest effective rates of tax on investment capital and that it is one of the few first-world countries which has not yet "integrated" its corporate-level tax. Finally, their adoption would disadvantage U.S. financial institutions in their efforts to compete with foreign financial institutions.

II. *Require Accrual of Time Value Element on Forward Sale of Corporate Stock*

The Administration's FY 2000 budget includes a proposal to effectively treat a corporation which agrees to issue shares of its stock in the future (a so-called "forward sale" of its own stock) as if it had (a) issued its stock on the date of the agreement in exchange for a smaller amount of cash, and (b) lent this smaller amount of cash back to the deemed purchaser of the stock for the period between the date of the agreement and the date of actual issuance of the stock. The excess of the amount which the company actually received in the future over the amount which the company was deemed to receive today would be taxable interest income, rather than a nontaxable receipt of property in exchange for the issuance of stock.

The basis for this proposal, according to the Administration, is that a corporation's agreement to sell its own stock in the future is economically equivalent to selling its stock today and lending the proceeds of the sale back to the purchaser of the stock. SIA believes, however, that there are several problems with the Administration's logic.

First, our system imposes tax by reference to the transactions which taxpayers actually enter into, not by reference to alternative transactions which taxpayers might have entered into, but didn't, to reach economically similar results. There are an infinite number of transactions which give rise to different tax results notwithstanding that they give rise to economic results that are arguably equivalent. The continued ownership of appreciated property is economically equivalent, for example, to selling it and buying it back again, and holding debt is economically equivalent, for example, to holding stock, selling an at-the-money call on that stock and buying an at-the-money put on that stock. We therefore do not think it desirable to seek to tax financial transactions on the basis of their economic similarity to other financial transactions.

Second, an agreement to issue stock in the future is *not* economically similar to an issuance of stock today. A taxpayer who merely agrees to purchase stock in the future lacks (a) the right to dividends on the stock, (b) the right to vote the stock and (c) the ability to dispose of, or pledge, the stock. In short, the taxpayer lacks all of the current benefits and indicia of ownership.[1] Such a taxpayer is not ever exposed to the risk of the issuer's bankruptcy, because a forward contract to acquire issuer stock is generally void in the event of the issuer's bankruptcy.

Third, there is no economic similarity, as posited by the Administration, in the case of a stock which pays dividends. If the relevant stock pays dividends equal to the market rate of interest, for example, the "forward price" of the stock generally equals the current price of the stock, and treating as interest a portion of the amount received in the future for the stock would be theoretically incorrect. Put differently, under the more typical circumstance in which the relevant stock pays dividends, the Administration's proposal would in effect treat a forward issuer as making deemed nondeductible dividend payments on deemed currently issued stock and immediately receiving those payments back again as includable interest income.

Fourth, far from increasing tax equivalence and consistency, adoption of this proposal would create inconsistency by deeming certain events to occur for purposes of determining the tax treatment of a forward issuer of stock but not for purposes of determining the tax treatment of the forward purchaser of stock. Thus, the proposal would require an issuing corporation to recognize income from a deemed receipt of interest from the purchaser, but it would not permit the purchaser to deduct deemed payments of interest to the issuing corporation. We think that such inconsistent and one-sided treatment violates the basic fairness principles underlying sound tax administration.

Finally, the harsh treatment accorded future sales of a corporation's stock would effectively prevent corporations from agreeing to issue their stock in the future. Yet there are legitimate business reasons for agreeing to issue stock in the future. For example, an issuer may believe that its stock is temporarily overpriced but not yet have any use for the cash proceeds of a current stock issuance. We see no reason to interfere with capital markets in this manner.

III. *Modify Rules for Debt-Financed Portfolio Stock*

Section 246A of current law[2] disallows the dividends-received deduction to the extent that relevant portfolio stock is debt financed. Portfolio stock has generally been treated as debt-financed where (a) it is acquired with the proceeds of indebtedness, or (b) it secures the repayment of indebtedness. The Administration's FY 2000 budget includes a proposal to attribute general corporate indebtedness pro-rata to a corporation's assets for purposes of treating the corporation's portfolio stock as debt-financed, regardless of how or why the indebtedness is incurred. This means that the dividends-received deduction would be partially disallowed for most corporations. Enactment of this proposal would therefore be equivalent to substantially

[1] See Staff of Joint Comm. on Taxation, 106th Cong., *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* 179 (Comm. Print JCS–1–99) (hereafter, the "*Joint Committee Description*").

[2] All section references are to the Internal Revenue Code.

reducing the dividends-received deduction. The effective reduction would depend on the leverage of the relevant corporation, however, and the deductions of highly leveraged corporations, such as most financial institutions, would be greatly reduced.

SIA objects to this proposal. The dividends-received deduction is designed to prevent multiple levels of corporate taxation from being imposed on the same dollar of earnings when corporations invest equity capital in other corporations. SIA believes that this deduction plays an essential role in the economy and should be increased, rather than reduced. The deduction permits the free flow of equity capital from "mature" corporations with limited economic opportunities to "growth" corporations which can employ the capital to expand the economy. Absent the deduction, the government would be imposing multiple-level corporate taxation on capital seeking its most productive use.

Congress recognized the essential role of the dividends-received deduction when it first enacted Section 246A of the Code in 1984. The provision was enacted to deal with a relatively narrow concern. The relevant "blue book" contains the following language, for example: "Specifically, under prior law, corporate taxpayers were borrowing money and using the proceeds to acquire dividend-paying portfolio stock . . .. If the indebtedness was non-recourse, the transaction may have involved little risk and, if properly structured, may not even have had to be fully reflected on the investing corporation's balance sheet."[3] Congress made it quite clear, however, that it did not intend a broad disallowance. The relevant House Report contains the following language:

> "The bill contemplates that the directly attributable requirement will be satisfied if there is a direct relationship between the debt and an investment in stock. The bill does not contemplate the use of any allocation or apportionment formula or fungibility concept. Thus, for example, the bill does not apply merely as a result of (i) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program or (ii) deposits received by a depositary institution as a part of the ordinary course of its business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying stock or otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, if stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness. The same result would follow with respect to any nonrecourse loan secured, in whole or in part, by dividend-paying stock.[4]

The Administration has not pointed out any change in circumstance which might lead Congress to change its mind.

We are also troubled by the inequity of the Administration's proposal. We do not see why the dividends-received deduction should be effectively disallowed for securities dealers or disallowed in proportion to corporate leverage. Securities dealers, which are almost always highly leveraged, maintain equity portfolios in the ordinary course of business for reasons that are wholly unrelated to tax.

In any case, we think this proposal would have several undesirable collateral consequences. First, it would encourage corporations to lend capital to other corporations, rather than make equity investments. The resulting increase in corporate leverage would weaken the stability of the corporate sector and result in needless and costly bankruptcies in the event of an economic downturn. Second, it would reduce the international competitiveness of U.S. corporations by effectively increasing the rate of U.S. corporate-level taxation, a rate which is already much higher than the rate imposed on foreign competitors by many of our trading partners, most of which have already integrated their corporate-level taxes. Third, it would disrupt capital markets by leading to sudden and unanticipated drops in the secondary market values of preferred and other yield-oriented equities that were issued assuming no "haircut" for corporate leverage. Finally, for the reasons set out above, it would impede securities dealers from holding significant inventories in such equities in order to stand ready to buy or sell them (*i.e.*, to "make a market" in those equities), thereby diminishing the liquidity of such equities and further exacerbating the problems set out above.

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[3] *1984 Blue Book* at 128.

[4] H.R. Rep. No. 98–432, pt. 2, at 1184 (1984). The relevant Senate report contains almost identical language. *See* S. Rep. No. 98–169, at 165–66 (1984).

IV. *Deny the Dividends-Received Deduction for Certain Preferred Stock*

The Administration's FY 2000 budget also includes a proposal to disallow the dividends-received deduction all together for dividends received on term preferred stock (*i.e.*, stock that will likely be redeemed within 20 years) and floating-rate preferred stock (*i.e.*, stock with dividend rates which vary with interest rates, commodity rates or similar indices). For reasons similar to those set out in III. above, SIA objects to this proposal. Indeed, Congress considered and rejected this proposal last year.

According to the Administration, the rationale for this proposal is that such stock has debt-like characteristics. This is not an argument, however, for disallowing the dividends-received deduction. Under current law an issuer of preferred stock does not get any interest deduction, and the issuance of preferred stock rather than debt therefore generally increases, rather than decreases, aggregate corporate-level tax by introducing an additional 10.5% tax on dividends (*i.e.*, a 35% tax on the 30% of the dividend that is taxable).

The Administration also maintains that the proposal is justified because current law denies the dividends-received deduction where holders are protected from risk of loss. Congress has already concluded, however, that the dividends-received deduction should not be disallowed merely because the terms of the preferred stock are designed to insulate a holder from market risks such as changes in interest rates.[5] Such terms do not protect the holder from the key risk which distinguishes equity from debt for tax purposes: the risk that the issuer will not pay dividends if its business performs poorly. Neither is a holder of preferred stock protected from this risk merely because the stock is scheduled for ultimate redemption. The stock is never redeemed if the issuer becomes insolvent prior to redemption, in which case the holder has no creditor's claim. The holder may receive neither dividends nor the redemption price if the issuer lacks sufficient earnings, and in such a case the holder cannot sue the issuer to enforce payment.

In any case, we see no basis for selectively eliminating the dividends-received deduction for particular classes of preferred stocks. The Administration's proposal is unfair and one-sided, because it would deny a dividends-received deduction on the theory that the security is "debt," but it would not grant an interest deduction instead. The result would make it impossible to issue the relevant securities, because the securities would fall into a noneconomic "no man's land" for tax purposes. There are important and legitimate business reasons, however, why some corporations investing equity capital in other corporations receive term preferred stock rather than perpetual preferred stock, or floating preferred stock rather than fixed preferred stock. We do not see any reason to force capital markets to limit the means by which domestic corporations can provide each other with equity capital.

V. *Defer Interest and OID Deductions on Certain Convertible Debt*

The Administration's FY 2000 budget contains a proposal to defer deductions for interest accruing on zero-coupon debt that is convertible into the stock of the issuing corporation until the interest is actually paid. If the holder exchanged the right to receive such accrued but unpaid interest for stock before the instrument matured, the interest deduction would effectively be disallowed all together. This proposal has been repeatedly considered and rejected by Congress since 1995.

We oppose this provision as lacking a coherent policy rationale. The only possible rationale for the proposed disallowance is that an issuance of convertible discount debt is economically similar to an issuance of equity, and an issuer should therefore not be entitled to deduct interest accruing on discount debt that is ultimately converted into equity. We assume that the Administration would not propose, however, to disallow deductions for interest paid on conventional current-pay convertible debt. As an empirical matter, current-pay convertible debt is far more likely to be converted into equity than is zero-coupon convertible debt. A converting holder of zero-coupon debt must give up the right to receive accrued but unpaid interest; a converting holder of current-pay debt does not give up this right, because the interest has already been received. This is borne out by the fact that most current-pay convertible debt instruments are ultimately converted into stock prior to maturity, whereas most zero-coupon convertible debt instruments are ultimately *not* converted. In other words, it is generally the zero-coupon instruments, not the current-pay instruments, which in fact pay principal at maturity.

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[5] See *e.g.*, H.R. Conf. Rep. No. 98–861, at 818–19 (1984), dealing with the enactment of Section 246(c) of the Code: "The substantially similar standard is not satisfied merely because the taxpayer (1) holds a single instrument that is designed to insulate the holder from market risks (*e.g.*, adjustable rate preferred stock that is indexed to the Treasury Bill rate). . . ."

Moreover, this provision would result in inconsistent treatment of issuers and holders. Issuers would be denied any deductions for accrued but unpaid original issue discount, yet holders would still be required to include such discount in income. We think this would be unfair as a matter of policy.

VI. *Tax Issuance of Tracking Stock*

"Tracking stock" is an economic interest (*e.g*., stock) which "tracks" the economic performance of one or more divisions or subsidiaries of the issuing corporation. The Administration's FY 2000 budget includes a proposal which would require a corporation to recognize gain upon the issuance of tracking stock in an amount equal to the excess of the fair market value of the tracked assets over their adjusted basis. According to the Administration, the rationale for this proposal is that issuing corporations are avoiding the gain which they would otherwise recognize if they sold stock in the tracked subsidiary or division.

We disagree with the assumptions underlying this proposal. In many cases, the proceeds of an issuance of tracking stock are contributed to the relevant tracked subsidiary or division. Thus, the overall transaction is economically equivalent (and could be replicated by) a *primary* issuance of stock to new investors by the relevant subsidiary or division. Such a primary issuance would "dilute" the parent's interest in the subsidiary but would not cause the parent to recognize gain. We therefore do not agree that the issuance of tracking stock is primarily designed to avoid recognition of gain.

Admittedly an issuance of tracking stock is sometimes chosen over the alternative of a primary issuance partly to prevent the relevant subsidiary from being "deconsolidated" from the parent. There are many legitimate business reasons, however, for choosing an issuance of tracking stock over a primary issuance, including (a) the issuer's desire to retain full economic control over (but not full economic participation in) the relevant subsidiary, (b) the desire to permit both parent and subsidiary to achieve the lower financing costs associated with a higher credit rating based on a stronger, unified credit, (c) the desire to obtain or avoid desirable or onerous accounting or regulatory objectives or consequences, and (d) the desire to maximize synergies and cooperation. Further, enactment of this proposal would leave corporations which have already issued tracking stock in an untenable position. Such corporations must issue new equity on an ongoing basis to grow, make acquisitions and meet other business requirements. If this new equity cannot be issued in proportion to existing equity (*i.e*., cannot include issuances of new tracking stock on a pro-rata basis), the balance in the corporation's capital structure will be undermined.

As discussed above in connection with the Administration's proposal to treat a forward issuance of stock like an "economically equivalent" current issuance, SIA does not believe that taxpayers should be taxed by reference to economically similar transactions which they might have undertaken to reach their economic objectives but didn't. Moreover, an issuance of tracking stock is clearly not economically equivalent to a sale of stock in the tracked subsidiary. Among other things, such an issuance (a) leaves investors fully exposed to loss from the bankruptcy of the issuing corporation, (b) generally gives investors voting control over the issuing, rather than the tracked, corporation and (c) subjects investors to substantial limitations on the receipt of dividends or profits which relate to the performance of the issuing, rather than the tracked, corporation.[6]

"While it generally is anticipated that the issuing corporation will pay dividends linked to the tracked assets, in many instances holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends. The tracked assets may be subject to liabilities of the parent corporation that may diminish the tracking stock shareholders' interests in the values of such assets. Under such circumstances, it might be questioned whether the issuance of such stock is economically equivalent to a direct ownership of the underlying assets. If tracking stock has a value that differs from the value of the underlying assets, it could be questioned whether the issuing corporation is properly treated as having distributed the entire value of the attributable portion of the tracked asset."

VII. *Apply Section 265(b) to Securities Dealers*

Section 265(a)(2) generally disallows deductions for interest on indebtedness incurred or continued to purchase or carry tax-exempt debt. Under relevant case law and IRS regulatory authority, securities dealers are generally required to allocate their indebtedness pro-rata among their assets for this purpose, with certain excep-

[6] See the *Joint Committee Description* at 224–225:

tions where indebtedness proceeds are clearly traceable to purposes other than the acquisition of tax-exempt debt. Section 265(b) applies a blanket pro-rata allocation rule to banks and other financial institutions.

The Administration's FY 2000 budget includes a proposal to apply Section 265(b) to securities dealers. The stated purpose of this proposal is to deny securities dealers the right to trace the proceeds of certain borrowings to specified taxable investments. This proposal, if adopted, would effectively overturn 30 years of guidance concerning what portion of a securities dealer's indebtedness is deemed effectively incurred to carry inventories of tax-exempt securities.

More specifically, when Congress first enacted Section 265(a)(2) of the Code in 1917, it clearly did not desire a pro-rata disallowance of interest expense for general business purposes.[7] In fact, Congress considered whether to amend the predecessor to section 265(a)(2) to enact a pro-rata disallowance rule in 1918, 1924, 1926 and 1934, and each time explicitly refused to do so.[8] Thereafter, the Second Circuit, in *Leslie v. Commissioner*,[9] concluded that securities dealers must allocate general subordinated indebtedness pro-rata among their business assets for purposes of applying Section 265(a)(2) but conceded that Section 265(a)(2) is not properly applied to disallow interest deductions where "business reasons not related to purchase of tax-exempt securities dominate the incurring of indebtedness." It allowed the Commissioner to allocate the taxpayer's indebtedness pro-rata among its business assets only because the proceeds of the indebtedness could not be traced to the acquisition of taxable assets. Likewise, under Rev. Proc. 72–18,[10] the Internal Revenue Service generally requires securities dealers to allocate their indebtedness pro-rata among their business assets but recognizes that such allocation is inappropriate where indebtedness is incurred for certain specified purposes.[11] Similarly, in *Rev. Rul.* 74–294,[12] the Service concluded that indebtedness incurred to make margin loans to customers was not allocable to tax-exempt debt because the indebtedness proceeds had to be segregated in a separate account.

The objective of all of these authorities has been to carry out the will of Congress as regards the application of Section 265 to securities dealers. In pursuance of this goal, these authorities have generally required pro-rata allocation, but they have also recognized the fact that some indebtedness is clearly not incurred to carry tax-exempt debt. The only rationale advanced by the Administration for reversing all of this guidance is that specific identification is not available to banks. Yet banks do not, like securities dealers, generally hold inventories of tax-exempt debt securities for sale to customers in the ordinary course of business. To the extent that they do, they also should be entitled to specific identification. Uniformity of treatment should not be sought by extension of a flawed rule.

In fact, the rule proposed by the Administration would be exceedingly harsh on securities dealers. Consider, for example, a securities dealer maintaining a "matched book" of repo transactions whereby the dealer effectively borrows and onlends large amounts of cash (which borrowings and onloans are fully collateralized by Treasury securities) and earns a thin "spread" for its corresponding role as a "middleman" in the efficient flow of capital. Under the Administration's proposal, such a dealer would be required to allocate the "borrowings" pro-rata among its assets, including its inventory of tax-exempt securities, and a portion of its deductions for interest paid on the borrowings (but not its income from the onloans) would be disallowed accordingly. In effect, the net taxable income from the transactions would substantially exceed the economic income. Similarly, where a securities dealer borrowed money and onlent the proceeds to a customer in connection with a customer margin account, the resulting taxable income would substantially exceed the net economic income. Such treatment would hamper the ability of U.S. securities dealers to compete effectively with foreign securities dealers. If and to the extent that current rules have a similar effect on banks (*i.e.*, to the extent that banks make markets in tax-exempt debt), we think the rules for banks should be changed.

The Administration maintains that "it is difficult to trace funds within an institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings." To the contrary, however, the IRS has successfully audited securities dealers under an allocation methodology which includes both pro-

[7] Revenue Act of 1917, ch. 63, §§ 1201(1) & 1207(2), 40 Stat. 300, 330, 335 (1917).

[8] *See* J.S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws 1938–1961* 301, 597, 727–28, 910 (1938).

[9] 413 F.2d 636, 639 (2d Cir., 1969), *cert. den.* 396 U.S. 1007 (1970).

[10] 1971–1 C.B. 740.

[11] *Id.* at Section 5.04: Indebtedness incurred to acquire or improve physical facilities is not allocated partly to tax-exempt debt.

[12] 1974–1 C.B. 71.

rata allocation and specific tracing since the introduction of its 1972 revenue procedure on the subject.

VIII. *Require Current Accrual of Market Discount by Accrual Method Taxpayers*

The Administration's FY 2000 budget includes a proposal which would require accrual-basis taxpayers to include the difference between the purchase price of a debt obligation and the issue price of the obligation—*i.e.*, the "market discount" on the obligation—in income as it accrues. The accrual rate would be limited to 5 percentage points above (a) the original yield of the debt or (b) the applicable federal rate of interest at the time the debt was acquired. The basis for this proposal, according to the Administration, is that the failure of current law to require current accrual of market discount "creates asymmetries between similarly situated holders."

Congress has provided for the deferral of market discount in light of its simplicity and its consistency with the treatment of the issuer. Like the issuer, all holders continue to accrue interest at a rate equal to the initial yield of the debt instrument, regardless of subsequent changes in the value of the debt arising from changes in circumstance (*e.g*., changes in the market rate of interest or credit worthiness). Congress has also provided for the deferral of market discount partly in consideration of the administrative difficulties associated with requiring cash-basis holders to measure and accrue such discount currently.[13]

In light of the above, we believe that it is this proposal, rather than current law, which would create asymmetries. The proposed treatment of accrual-basis holders would not be consistent with the treatment of cash-basis holders, who would still (for the reasons set out above) be permitted to defer the inclusion in income of market discount to maturity. We do not think it fair or advisable to impose a substantially less desirable tax treatment on a category of investors based solely on their accounting method.

We are also concerned about the policy implications of this proposal. Current market discount rules generally encourage investors to acquire distressed debt in the secondary markets. The resulting increase in the liquidity of such debt helps to stabilize the financial positions of troubled corporations. Similarly, current market discount rules help increase the liquidity of Treasury and other government securities in rising interest-rate environments. We believe the Administration should set out in greater detail the likely economic impact of this proposal.

IX. *Modify and Clarify Straddle Rules*

The Administration's FY 2000 budget includes a proposal designed to "clarify" that taxpayers cannot currently deduct certain expenses and losses that are attributable to structured financial transactions that are part of a straddle. We think this proposal is too broad. The proposal would disallow current deductions for *all* expenses incurred in connection with a straddle, even though the expenses are not incurred to purchase or carry the straddle and even though the expenses are not related to increases or decreases in the value of the underlying property.[14] In the case of a typical 5-year exchangeable debt instrument, for example, the proposal would disallow deductions for fixed conventional market-rate interest payments (*e.g*., 7% per annum), even though the proceeds of the borrowing were used for wholly unrelated purposes and the relevant growth stock did not serve as collateral for the borrowing.

If the straddle rules are modified, moreover, we think the modifications should also deal with rules which currently work against taxpayers in an unfair manner. For example, under current straddle rules, a small loss can be deferred even though larger amounts of gain have been recognized on the offsetting position, because there is still some unrecognized gain left in the offsetting position (*e.g*., unrealized gain which antedated the straddle). Likewise, losses can be deferred to the extent of unrealized offsetting gains, but gains are never deferred to the extent of unrealized offsetting losses. Partly in recognition of these facts, the Administration last year proposed to permit taxpayers to elect to treat straddles as hedging transactions and account for the timing of gains and losses on a unified basis. The Administration did not include this proposal among its proposals for hedging transactions this year, however. We think this proposal should be included as part of any current plan to change the straddle rules.

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[13] See the Joint Committee Description at 207, and Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 93 (Comm. Print 1984) (hereafter, "1984 Blue Book").

[14] See the *Joint Committee Description* at 217.

X. *The Administration's Corporate Tax Shelter Proposals*

The Administration's FY 2000 budget includes a group of proposals which respond to a perceived increase in corporate tax shelter transactions. These proposals would introduce a variety of penalties for attempting to obtain a "tax benefit" by entering into a "tax avoidance transaction." A "tax avoidance transaction" is generally defined to include (a) any transaction where the expected pre-tax profit is insignificant relative to the expected tax benefit, and (b) certain transactions involving "the improper elimination or significant reduction of tax on economic income." A tax benefit would include any reduction, exclusion, avoidance or deferral of tax that was not "clearly contemplated by the applicable provision."

The penalties would generally include all of the following: (a) automatic disallowance of the relevant tax benefits, regardless of what would otherwise be the outcome under current law, (b) automatic imposition of a substantial understatement penalty, (c) increase in the amount of the understatement penalty from 20% to 40%, (d) disallowance of all deductions for fees, including underwriting fees, paid to enter into the transaction, (e) imposition of a 25% excise tax on such fees, (f) imposition of an immediate 25% excise tax on the maximum amount which the taxpayer could conceivably collect from insurance, gross-up provisions, make-whole provisions or other mechanisms designed to compensate the taxpayer for loss of tax benefits and associated penalties, and (g) imposition of tax on otherwise tax-exempt or foreign persons who invest in, or otherwise participate in, the relevant transactions.

One of the principal tasks of the securities industry is to help corporations structure and implement financial transactions. SIA recognizes that the Administration is concerned about strictly tax-motivated transactions. Such transactions must be distinguished, however, from the much broader group of financial transactions that are not motivated primarily by tax considerations but are legitimately structured to minimize their tax consequences. The latter are often novel and complex, and the application of existing tax rules to them is often a matter of first impression. There are, moreover, numerous "gray areas" where the application of existing legal concepts is not entirely clear. The objective rules that are set out in statutes, regulations, case law and other official guidance are mostly "good" rules that have been carefully thought out and work well in most cases. SIA agrees that taxpayers should not be allowed to abuse these rules to avoid paying tax. The system as we know it will not work, however, if taxpayers cannot rely on these rules to determine the tax consequences of new financial transactions without fearing that their good faith efforts will be second guessed with drastic consequences. Moreover, a taxpayer's efforts to structure legitimate business transactions in the most tax-advantageous manner in light of these rules should not make them or their advisors the targets of legislation that is intended to deal with corporate tax shelter activity.

It is not easy (indeed it may be impossible) to define "tax avoidance transaction" in a way which effectively catches strictly tax-motivated transactions without catching the tax-motivated aspects of legitimate business transactions. The Administration's penalty proposals would place enormous pressure on this definition, however, by automatically imposing severe and redundant penalties on taxpayers purporting to derive tax benefits from tax avoidance transactions.

We note, moreover, that efforts to define "tax avoidance transaction" using such concepts as whether a transaction "improperly eliminates tax on economic income" or "creates a tax benefit which is not clearly contemplated by the applicable provision" introduces a "normative" concept which cannot be found in objective rules. The objective rules set out in our statutes and regulations are not necessarily economic. For example, some rules do not impose tax on economic gains, and other rules impose tax on noneconomic gains (*e.g*., impose tax on dividends). There is no "natural law" of federal income taxation. Thus, *no* statute or regulation can serve to determine whether a taxpayer has used objective rules to "improperly eliminate tax on economic income" or "create a tax benefit which has not been contemplated by the applicable provision." That is something which must be decided by individuals.

It follows that the efficacy of proposals based on such definitions must depend on the judgement and discretion of IRS agents. The additional steps required to structure a merger, acquisition, spinoff or other business transaction to be tax-free or tax-deferred, rather than fully taxable, can often be described as transactions entered into solely to avoid taxes. The same can be said of steps undertaken to structure financings in the most tax-advantageous manner while still addressing various accounting, regulatory, rating agency, foreign and domestic law concerns. If IRS agents were to treat such additional steps as tax-avoidance transactions, taxpayers might be forced to concede disputed technical issues to avoid the risk of onerous penalties. In any case, the IRS would have to substantially increase its resources to permit it to work through a large volume of complex financial transactions, analyze the underlying intent of the relevant objective rules and do so on a basis that was timely enough to permit business to proceed without serious interruption.

Statement of Security Capital Group Incorporated, Santa Fe, New Mexico, and SC Group Incorporated, El Paso, Texas

This statement is submitted on behalf of Security Capital Group Incorporated of Santa Fe, New Mexico and its subsidiary, SC Group Incorporated of El Paso, Texas (collectively "Security Capital") for inclusion in the record of the hearings held by the Committee on Ways and Means on March 10, 1999 concerning the Administration's tax legislative proposals for fiscal year 2000. In those proposals, the Administration recommended legislation, supported in principle by Security Capital, dealing with taxable REIT subsidiaries. The Administration also renewed its prior request for legislation to prohibit the use of closely-held REITs. This statement is directed to the closely-held REIT proposal.

As described in Treasury's General Explanation of the Administration's Revenue Proposals a new requirement would be established for REIT status such ". . . that no person can own stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock." In support of this change, the General Explanation states that the Administration "has become aware of a number of tax avoidance transactions involving the use of closely held REITs." (General explanation at p. 142).

Security Capital does not disagree with the view that Congress should address situations involving the inappropriate use of provisions of the Internal Revenue Code for unintended purposes. At the same time, however, Security Capital remains unconvinced that a broad prohibition on all closely-held REITS is necessary to prevent improper tax avoidance. In confronting past uses of the REIT structure in ways believed by policy-makers to be inappropriate, both the Administration (in the case of step-down preferred transactions) and Congress (liquidating REIT transaction) have taken a targeted approach. In Security Capital's view this is the most appropriate way to proceed and it seems desirable to take this approach with respect to closely-held REITs.

If, however, Congress does adopt the Administration's proposed blanket prohibition on closely-held REITs, it should structure the legislation so that it will meet the Administration's objective of *not* "frustrating the intended viability of REITs." (General Explanation at p. 142). As discussed more fully below, this requires that there be a specific exception for so-called "incubator" REITs. Otherwise, the proposed restriction on closely-held REITs would effectively prohibit the use of the REIT structure as the vehicle to enter a new market or new line of real estate and build the business from the ground up, culminating in a "going public" transaction. Such effects *would*, in Security Capital's view, frustrate "the intended viability of REITs."

IMPORTANCE OF INCUBATOR REITS

There are numerous examples of publicly-held REITs that were, when first formed, closely-held REITs. Among the REITs which started as so-called "incubator" REITs are Security Capital's industrial distribution REIT (the nation's largest), and a portion of its multi-family housing REIT (the nation's second largest). "Incubator" REITs which have developed into widely-held REITs have created jobs and opportunities for thousands of Americans, and through the taxes paid on the dividends they issue to shareholders, have resulted in additional revenues to the Treasury. For example, the development of "incubator" REITs has been a major factor in the growth at our client's El Paso facility from 12 to 536 employees.

"Incubator" REITs are formed with the specific expectation that they will become public after an appropriate "incubation" period. In most cases, the specific intent to "go public" has been evident from the outset in, for example, the REIT's financing documents. This period normally takes at least three years (perhaps a year or two longer in some cases depending on market conditions). During this incubation period, the REIT assembles a staff, raises initial interim capital to finance the acquisition of a portfolio of properties, operates the acquired properties and otherwise develops the type of "track record" necessary for a successful "going public" transaction.

Security Capital believes that "incubator" REITs have been an important component in the industry's ability to fulfill the goals set forth by Congress when it created the REIT structure. They are the building blocks upon which successful, widely-held REITs have been built, enabling small investors to participate in large scale, income producing real estate and allowing the capital of many to be united into a single economic enterprise.

WHY "INCUBATION" REQUIRES USE OF A REIT VEHICLE

Use of a closely-held REIT (as opposed to a "C" corporation or partnership) during the incubation period is necessary if the "incubator" is to develop into a widely-held public REIT. Some have questioned whether this necessity is limited to the intangible benefit of increasing the likelihood of favorable reviews from one or more investment analysts at the time of the "going public" transaction. Security Capital questions whether any such market perceptions about the desirability of use of the REIT structure from outset can be prudently ignored by those who seek access to the public capital markets. Nevertheless, even if such perceptions did not exist, there would remain other important and substantive considerations that, in Security Capital's view, make use of a closely-held REIT during the incubation period highly important from a non-tax standpoint.

Use of a "C" corporation during the incubation period would place the entity at a competitive disadvantage. A key activity during the incubation period is the solicitation of initial capital from third parties in order to finance the acquisition of the portfolio of properties that will form the basis for the "going public" transaction. The third party providers of such initial capital demand returns that are commensurate with those obtainable from other similar investments in real estate (i.e., significant current dividends such as those paid by REITs). In those limited instances where "C" corporations are used with respect to real estate, investors typically receive far more modest dividends and the emphasis is on long term appreciation in value. The incremental cost of providing REIT-level current returns through dividends in a "C" corporation structure obviously would be quite significant and this added cost would in turn limit the ability of the entity to compete for property during the incubation period. We estimate that this disadvantage is equal to approximately 160 basis points on property yields.

Use of a partnership during the incubation period would likewise be detrimental from a business point of view. First and foremost, there are some investors who will not invest in partnerships due to illiquidity concerns and historical abuses. By foreclosing the REIT vehicle, these incubator companies will further be at a competitive disadvantage. Additionally, a partnership creates significant administrative burdens and builds in detrimental conflicts of interest. Following the "going public" transaction, the REIT would be required to use a carryover basis for any properties carried on the partnership's books at historic cost. Where, as is often the case, historic cost differs from current value, there could undoubtedly be conflicts of interest between the initial providers of capital and the new public investors on matters such as the selection of properties to hold or to sell. In addition, in some cases, public shareholders could experience an immediate dilution attributable to the combination of carryover basis and the fixed minority ownership percentage of the original partners. Finally, as in the case of a "C" corporation, multiple sets of records would be required to account for the entity as a "C" corporation or partnership for tax purposes and to establish a track record of REIT qualification and performance.

As discussed below, Security Capital believes that an appropriate incubator REIT exception can be structured with sufficient safeguards to prevent use of qualifying incubator REITs for the type of tax avoidance transactions that prompted the Treasury to propose the closely-held REIT prohibition in the first instance.

KEY COMPONENTS OF INCUBATOR REIT EXCEPTION

In Security Capital's view, a bona fide incubator REIT possesses a series of characteristics that should form the basis of an exception from any general prohibition on closely-held REITs. First, an incubator REIT typically receives at least some of its initial capital from unrelated investors. In contrast, closely-held REITs of the type with which Treasury apparently is concerned are typically held almost exclusively by one party or a group of related parties. Second, an incubator REIT typically increases its real estate holdings through acquisition and/or development by some amount progressively over the incubation period. In contrast, a closely-held REIT frequently has a static portfolio of assets. Third, an incubator REIT typically operates its real estate assets directly, whereas closely-held REITs formed by non-real estate businesses generally do not engage in such operational activities. Fourth, incubator REITs from the outset typically take actions (e.g., securing audited financial statements) that will be required following the "going public" transaction. Finally, an incubator REIT typically documents a specific intent to engage in a "going public" transaction and such expressions of specific intent appear in private placement memoranda, loan memoranda and similar documents.

If Congress views these five distinguishing characteristics of bona fide incubator REITs as insufficient in and of themselves to permit structuring an exemption with adequate assurance against tax avoidance transactions, one or more additional requirements could be imposed to limit any perceived potential for abuse. For example, the time period for which incubator REIT status would be available could be limited to a stated number of years. If a "going public" transaction had not been completed by the end of the stated period, REIT status would thereafter be lost. To accommodate market conditions, however, the initial incubation period could be extended for an additional period, such as 24 months, but all tax benefits attributable to such extended period would be subject to recapture (with interest) unless a "going public" transaction was in fact consummated during that additional period. There is precedent for such a recapture regime (e.g., sections 1291–1297 of the Internal Revenue Code relating to passive foreign investment companies) and it could be buttressed with an appropriate transferee liability rule.

In addition, during the incubation period, the REIT could have only a single class of stock. Security Capital understands that many of the tax avoidance transactions with which Treasury is concerned either require or would be facilitated by more complex capital structures. These complex structures are not integral to the incubator REIT process and Security Capital sees no objection to prohibiting them as part of a properly crafted exemption.

Security Capital looks forward to continuing to work constructively with the Administration and Congress in connection with the development of legislation to enable REITs to continue effectively to serve their important economic functions.

Statement of Stock Company Information Group

This testimony is submitted on behalf of the members of the Stock Company Information Group who are listed on the last page hereof. The Stock Information Group was formed in 1981 to address Federal legislative and regulatory issues affecting the stock life insurance companies and to participate in the development of a revised income tax structure for life insurance companies. We thank the Committee for the opportunity to comment on the Administration's proposal relating to policyholders surplus accounts.

While the Stock Information Group believes that each of the Administration's proposals relating to the taxation of life insurance companies and their products should be rejected as lacking in merit, this statement is limited to the proposal to take into income over ten years amounts represented by pre–1984 "policyholders surplus accounts" as described in Internal Revenue Code section 815.

BACKGROUND

The history of taxing life insurance companies reflects a struggle to reach what, at any given point in time, is viewed as the proper measure of a life insurance company's taxable income and the proper rate at which to tax that income. Prior to 1959, life insurance companies were taxed only on their investment income. Their underwriting (i.e., premium) income was not taxed, and underwriting expenses were not deductible.

In 1959, Congress changed the tax framework for life insurance companies in an effort to tax life insurance company income more accurately. The new tax structure sought to tax the life insurance industry on a broader, more comprehensive measure of income, considering not only investment income, but also underwriting income. Under this structure, all life insurance companies paid tax on investment income that was not set aside for policyholders. In addition, life insurance companies paid tax on one-half of their underwriting income.

Under the provisions of section 815 of the Internal Revenue Code, the other half of underwriting income for stock life insurance companies was not generally to be taxed unless distributed to shareholders of the life insurance company. Income that was not to be taxed unless distributed to shareholders was treated as part of a "policyholders surplus account" or "PSA." Mutual life insurance companies were not required to establish policyholders surplus accounts because they generally distributed the underwriting component of their income back to policyholders in the form of deductible dividends. In this manner, the 1959 tax structure sought to tax the proper amount of a life insurance company's income, irrespective of whether the company was a stock or a mutual.

In 1984, Congress again revised the income tax rules for life insurance companies. Once again, Congress focused its effort in seeking a clearer reflection of income. Dividend deductions for mutual life insurers were limited. Additions to the policyholders surplus accounts of stock companies were discontinued, but existing accounts were not subjected to tax.

Congress recognized that this broader tax base would result in too great a tax burden on life insurance companies if they were taxed at the generally applicable corporate tax rate. Thus, Congress decided to include a provision which would have the effect of reducing the corporate tax rate from 46 percent to 36.8 percent for life insurance companies. When the general corporate rate was reduced to 34 percent in 1986, the special provision for life insurance companies was considered no longer necessary and was repealed.

Issue

What is at issue today is whether life insurance companies with historical policyholders surplus accounts should be subjected to an additional retroactive tax burden in 1999. In 1984, when Congress chose to deny further additions to policyholders surplus accounts, it explicitly decided not to subject these accounts to tax unless one of the specific events described in the statute (principally dissolution of the company) occurred. Due to the structure of prior law, if these accounts had been subjected to tax, the new law would have increased the taxes of one portion of the life insurance industry, a result that Congress believed was unfair.

What is just as important, however, in the context of today's issue, is that Congress did not believe that taxing these accounts was necessary in order to properly measure taxable income. In 1984, Congress knew that very little tax was paid, or would be paid, with respect to these "old" policyholders surplus accounts. Congress' action in 1984 reflected a recognition that these historical accounts served, in their time, as an appropriate mechanism for computing the taxable income of one segment of the life insurance industry. Under that 1959 tax structure, taxable income was computed, and the tax was paid. Congress saw no need or reason in 1984 to increase "artificially" the taxable income of companies with policyholders surplus accounts.

Why the Administration's Proposal to Trigger Tax on Policyholders Surplus Accounts Should Be Rejected

What was true in 1984 is just as true today: Companies with policyholders surplus accounts have already paid their fair share of taxes under the tax provisions that applied to them at the time. To tax these accounts today would unfairly impose a retroactive tax on business conducted well over fifteen years ago.

The proposal does not close a loophole. It does not repeal an unintended tax benefit. Congress explicitly provided that, with certain minor exceptions, there would be no tax on policyholders surplus accounts absent distribution to shareholders. The Administration's proposal is simply a retroactive tax increase totaling more than $1 billion over five years (and twice that amount over ten years) on the approximately 600 life insurance companies which have policyholders surplus accounts.

The life insurance industry already pays Federal income taxes at a significantly higher rate than corporations in other industries. According to a recent Coopers & Lybrand study, the average effective tax rate for life insurance companies in the period from 1986 to 1995 was 31.9 percent. This compares to a rate of 25.3 percent for all U.S. corporations. From 1991 to 1995, the average effective rate for life insurance companies was 37.1 percent. It would be unfair to add to this already extraordinarily high rate by imposing a surtax in the form of a tax on policyholders surplus accounts.

In addition to the economic consequences of such a large tax increase, there would also be significant financial statement consequences. If the Administration's proposal were enacted, the 600 affected companies would be required under Generally Accepted Accounting Principles ("GAAP") to reduce their earnings reported to shareholders for the full amount of the tax liability in the year of enactment. This negative impact on earnings would result even if, as the Administration proposes, the tax is paid over ten years.

The Treasury Department description wrongly suggests that the policyholders surplus accounts concern old life insurance contracts which are no longer in existence and, as a result, the policyholder surplus accounts are somehow unnecessary today. This argument disregards the intention of Congress as expressed in section 815. Congress very explicitly stated the circumstances under which tax might be triggered. Determination of tax liability in no way is dependent upon the existence or termination of any particular contracts.

The Administration's proposal to tax policyholders surplus accounts implies that there exists an actual account or reserve fund from which the tax would be paid. This is not the case. The proposal is simply a surtax on certain life insurance companies, but payable out of current earnings and calculated by reference to premium income received over the years 1959 through 1983.

It is important to understand that the PSA is merely a tax memo account and has no meaning for any other purpose. Life insurance companies do not carry the PSA on any books and records other than those required for the federal income tax return, and there is no fund or segregated group of assets supporting the PSA.

In fact, the only financial reporting of the PSA under GAAP would be a note to the consolidated financial statements that the insurance companies have not accrued for any taxes associated with the PSA. In other words, the only evidence of the PSA in either GAAP or insurance regulatory financials is a note in the GAAP financials that the PSA exists for tax purposes but that the tax liability is never expected to become due.

This GAAP treatment originated in 1972, when, the predecessor of the Financial Accounting Standards Board issued an opinion, APB 23, on the appropriate accounting treatment of amounts deferred under section 815 which stated, in part, as follows:

> The Board concludes that a difference between taxable income and pretax accounting income attributable to amounts designated as policyholders' surplus of a stock life insurance company may not reverse until indefinite future periods or may never reverse. The insurance company controls the events that create the tax consequences and the company is generally required to take specific action before the initial difference reverses. Therefore, a stock life insurance company should not accrue income taxes on the difference between taxable income and pre-tax accounting income attributable to amounts designated as policyholders' surplus.

The conclusion of APB 23, as it concerns policyholders surplus accounts, was carried over in FAS 60, and, most importantly, the treatment was preserved in FAS 109 which currently governs financial accounting presentation of income taxes. Adopted in 1992, FAS 109 repudiated the APB 23 premise that taxes did not have to be accrued if they would be paid only in the indefinite future, but retained nonaccrual for only four items covered under APB 23, one of which was the PSA, and stated that a tax accrual would be required only if it became apparent that the tax would become payable in the foreseeable future. Thus, the accounting community recognized that neither the companies nor the government expected that the tax on the PSA would become due or payable.

Similarly, for state regulatory purposes, there has never been a requirement for the establishment of a liability, or an apportionment of surplus, for potential tax liability in connection with PSA's. In fact, there is no requirement that any potential liability be disclosed. State insurance departments would not regulate an insurance company any differently if it had no potential PSA tax liability or a billion dollar potential tax liability. This is simply because there is no expectation that this tax will ever be due.

Thus, there is no "fund," "reserve," "provision" or any other type of liability or allocation of assets on a life insurance company's statutory or GAAP financial statements to pay this proposed tax. Any additional tax imposed would reduce a company's current earnings in the year in which the legislation is enacted and ultimately would reduce the company's capital and surplus.

Conclusion

The Administration's proposal is simply a very large retroactive tax increase relating to business transactions which occurred over fifteen years ago. The proposal should be rejected.

STOCK COMPANY INFORMATION GROUP

Phase III Tax Member Companies

AEGON, USA
AETNA INC
ALLSTATE LIFE INSURANCE COMPANY
AMERICAN GENERAL CORPORATION
CIGNA CORPORATION
CONSECO
GE LIFE AND ANNUITY ASSURANCE COMPANY
HARTFORD LIFE INSURANCE COMPANIES
IDS LIFE INSURANCE COMPANY

ING NORTH AMERICA INSURANCE CORPORATION
JEFFERSON-PILOT CORPORATION
LINCOLN NATIONAL CORPORATION
MIDLAND NATIONAL
RELIASTAR LIFE INSURANCE COMPANY
TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
TRAVELERS INSURANCE COMPANIES
ZURICH KEMPER LIFE INSURANCE COMPANIES

Statement of Tax Council

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The Tax Council is pleased to present its views on the administration's budget proposals and their impact on the national economy and international competitiveness of U.S. businesses and workers. The Tax Council is an association of senior level tax professionals representing over one hundred of the largest corporations and business in the United States, including companies involved in manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, accounting, banking, and insurance. We are a nonprofit organization that has been active since 1967. We are one of the few professional organizations that focus exclusively on federal tax policy issues for businesses, including sound federal tax policies that encourage both capital formation and capital preservation in order to increase the real productivity of the nation.

The Tax Council applauds the House Ways & Means Committee for scheduling these hearings on the administration's budget proposals involving taxes. We do not disagree with all of these proposals. For example, we support (1) extending the tax credit for research, (2) accelerating the effective date of the rules regarding look-through treatment for dividends received from "10/50 Companies," and (3) making permanent the ability to currently deduct certain environmental expenditures. These provisions will go a long way toward improving the overall economy and the competitive position of U.S. multinational companies. However, in devising many of its other tax proposals, the administration has replaced sound tax policy with a shortsighted call for more revenue.

Many of the revenue raisers found in the latest Budget proposals introduced by the administration lack a sound policy foundation. Although they may be successful in raising revenue, they do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to (1) extend Superfund taxes without attempting to improve the cleanup programs, (2) repeal the use of "lower of cost or market" inventory accounting, (3) arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, (4) impose overly broad rules and draconian penalties on so-called "corporate tax shelters" giving unprecedented power to the IRS to disallow legitimate tax planning, (5) inequitably limit the ability of so-called "dual capacity taxpayers" (i.e., multinationals engaged in vital petroleum exploration and production overseas) to take credit for certain taxes paid to foreign countries, and (6) restrict taxpayers from having the ability to mark-to-market certain customer trade receivables.

In its efforts to balance the budget, the administration is unwise to target publicly held U.S. multinationals doing business overseas, and the Tax Council urges that such proposals be seriously reconsidered. The predominant reason that businesses establish foreign operations is to serve local overseas markets so they are able to compete more efficiently. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the U.S., along with improving the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal Revenue Code for over 70 years as a way to help alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals versus foreign-based companies.

In order that U.S. companies can better compete with foreign-based multinationals, the administration should instead do all it can to make the U.S. tax code more friendly and consistent with the administration's more enlightened trade policy. Rather than proposing provisions that reward some industries and penalizes others, the administration's budget should be written with the goal of reintegrating sounder tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and arbitrarily denying a deduction for such expenses will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

Corporate tax incentives like the research tax credit have allowed companies to remain strong economic engines for our country, and have enabled them to fill even larger roles in the health and well being of their employees. For these reasons, sound and justifiable tax policy should be paramount when deciding on taxation of business—not mere revenue needs.

POSITIVE TAX PROPOSALS

The administration's budget includes several tax provisions that would have a positive impact on the economy. We believe Congress should adopt these proposals, and in some cases (such as the research and experimentation tax credit), should go further than the administration has proposed.

Extend the Research and Experimentation Tax Credit.—The administration's proposal to extend the research tax credit for another year is laudable. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets—especially in what some refer to as the "Information Age." Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The Tax Council recommends the administration and Congress work together to make the research tax credit a permanent fixture of the tax code so that companies can rely on it when planning future additions to their research budgets.

Make Permanent the Expensing of Brownfields Remediation Costs.—The administration's proposal to make permanent the current deductibility of costs for so-called "brownfields" remediation under Code section 198 is a welcome extension of a change contained in the 1997 Taxpayer Act, which allowed certain remediation costs incurred with qualified contaminated sites (so-called "brownfields") to be currently deductible as long as they are incurred by December 31, 2000. Extension of this treatment on a permanent basis removes any doubts among taxpayers as to the future deductibility of these expenditures and promotes the goal of encouraging environmental remediation.

Simplify the Foreign Tax Credit Limitation for Dividends from 10/50 Companies.—The administration is commended for its proposal to accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between 10 percent and 50 percent by U.S. parents (so-called "10/50 companies"). This change will allow 10/50 companies to be treated just like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits ("E&P") generated before the year 2003, and dividends from E&P accumulated after the year 2002. The administration's proposal instead would apply the look-through rules to all dividends received in tax years after 1998, no matter when the E&P constituting the makeup of the dividend were accumulated.

This change would result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It also would reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws, and would go a long way toward helping the U.S. economy by strengthening the competitive position of U.S.-based multinationals.

Extend Carryback Period for NOLs of Steel Companies.—The administration's proposal to extend the carryback period for net operating losses ("NOLs") of steel companies from two to five years is both fair and equitable due to the financial troubles that many steel companies are experiencing. The benefit provided by this longer carryback period would feed directly into a financially troubled steel company's cash flow, providing immediate and necessary relief. Our only suggestion is that this longer carryback period be extended to other troubled industries, such as the petroleum, chemical, and aerospace industries, to name a few.

Simplify the Active Trade or Business Requirement for Tax-Free Spin-Offs.—Affiliated groups that utilize a holding company structure often must undertake a series of internal restructurings in order to satisfy the active trade or business best of section 355(b)(2) before a corporate subsidiary may be spun off to shareholders. These preliminary restructurings can be extremely costly and serve no purpose other than to satisfy the literal language of the current active business test. The administration has proposed to simplify the application of the active business test by applying it on an affiliated group basis. This proposal would eliminate the pointless and costly restructurings now required and represents real tax simplification.

Subpart F Active Financing Income.—We also urge the Congress to support a reinstatement and extension of the deferral of U.S. tax on the active financing income of foreign subsidiaries. Such an extension is vital to providing stability in the tax rules and allowing U.S. owned financial service businesses to compete effectively against their foreign competitors.

PROVISIONS THAT SHOULD BE RECONSIDERED

The Tax Council offers the following comments on certain specific tax increase proposals set forth in the administration's budget:

"Corporate Tax Shelters" v. Legitimate Corporate Tax Planning

The administration's sweeping attack on corporate tax planning is alarming and unwarranted. The administration's decision to seek a harsh new penalty regime and to impose Treasury and Internal Revenue Service judgements on taxpayers is disturbing. Use of a politically unpopular label such as "corporate tax shelters" does not justify the administration's attempt to intimidate taxpayers engaged in legitimate tax planning which might run afoul of the new tax shelter definition to be promulgated by Treasury.

The administration's proposals to address what it labels as tax avoidance transactions are overly broad and would bring within their net many corporate transactions that are clearly permitted under existing law. Legitimate tax planning to conform to domestic and foreign non-tax legal or regulatory requirements could well be subject now to confiscatory penalties for failure to satisfy these overly broad standards.

Is Strict Liability the Right Rule?.—The administration wants to impose strict liability in the form of a confiscatory 40-percent penalty on taxpayers who enter into transactions that IRS agents find uneconomic. That the taxpayer acted reasonably and in good faith or had a substantial business purpose for the transaction would not matter. This is simply the wrong standard. Business transactions and the tax laws that apply to them are complex. Taxpayers and the government inevitably will disagree. IRS agents should be encouraged to seek the correct amount of any tax payment. Taxpayers should be allowed to assert their views as freely as IRS agents.

Do We Need More Rules?.—Since 1982, the Internal Revenue Code has been littered with penalties, disclosures, confiscatory rates of interest, and endless amounts of reporting. More than 75 sections of tax laws enacted since 1982 directly address corporate compliance from a penalty or procedural perspective. Today, if a corporate taxpayer enters into a transaction it believes is less-likely-than-not to result in the claimed tax benefits, that taxpayer faces substantial exposure on examination. The resulting deficiency could carry a 20 percent understatement penalty. Both the deficiency and the penalty would accrue interest at penalty rates. An advisor selling the transaction could be subject to registration, promoter and aiding and abetting penalties, and discovery by other clients. Isn't this enough?

The administration's tax policy in this area is, at best, unclear. The administration complains tax shelters are ubiquitous in the corporate community, yet while large segments of American business have been abandoning the corporate form and moving to partnerships, limited liability companies, and S corporations, corporate tax revenues continue to grow.

These Proposals Would Cause Uncertainty.—The administration proposes five new rules built from a new concept: the tax avoidance transaction. A tax avoidance transaction is defined as one in which the reasonably expected pre-tax profit of the transaction (on a present value basis) is insignificant relative to the reasonably expected net tax benefits of the transaction (on a present value basis). A transaction also is deemed to be a tax avoidance transaction if it involves improper elimination or reduction of tax on economic income. In turn, a corporate tax shelter is defined as any entity, plan, or arrangement in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

This seemingly bright-line definition of a tax avoidance transaction is simply an invitation to an entirely new realm of ambiguity. Disputes would emerge over the general rules for measurement of profits; the treatment of non-deductible expenses and tax-free income; the reasonableness of expectations, discount rates, forecasting parameters; the allocation of general and administrative costs; the choice of applicable tax rates; assumptions about the state of the tax law; and dozens of other issues. As every member of the two congressional tax-writing committees knows from dealing with revenue estimates, it is much easier to know that an idea makes sense than to estimate its economic consequences with precision.

One bad answer to all of these questions is the probable Treasury response: We will tell you in regulations. No regulation adequately could resolve the issues raised by these new concepts. Taxpayers would be left with the choice of doing things the IRS way or risking a no-fault penalty.

To function efficiently and productively, business taxpayers must be able to depend on the rule of law. That means relying on the tax code and existing income tax regulations. If the administration's vague "tax shelter" proposals become law, few businesses would feel comfortable relying on those statutes or regulations. The administration's proposed rules could cost the economy more in lost business activity than they produce in taxing previously "sheltered" income.

The Tax Council Opposes Proposed Restrictions on Corporate Tax Planning

First, the provision imposing a 20-percent strict liability penalty on any underpayment associated with a tax avoidance transaction is wrong. Taxpayers should have the freedom to take reasoned, reasonable, and supportable positions on their tax returns. Increasing the penalty to 40 percent if the taxpayer failed to report its participation in the transaction within 30 days of entering into it is simply setting a trap for ordinary businesses. Tax lawyers and accountants are not at every business meeting ready to file reports to the IRS.

Second, Treasury's request for blanket regulatory authority to extend section 269 to disallow any deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction is nothing more or less than a request that the Congress turn over a substantial portion of its tax-writing responsibilities to un-elected executive branch officials.

Third, the administration wants Congress to deny corporate taxpayers any deduction for fees paid in connection with the purchase or implementation of a tax avoidance transaction or for related tax advice. Advisors also would be subject to a 25 percent excise tax on such fees, a provision that raises a host of procedural issues stemming from the fact that advisors are not party to audits or litigation that result in the 25-percent tax (e.g., would a separate proceeding be required before imposition of the tax, or would an advisor be required or permitted to intervene in an audit or litigation?). Corporate tax directors and their outside advisors are not criminals. By denying a deduction and imposing an excise tax, this proposal would provide harsher treatment under the tax code for legitimate tax-planning activity than that applicable to illegal bribes, kickbacks, penalties for violations of the law, and expenditures in connection with the illegal sale of drugs.

Fourth, purchasers of a corporate tax shelter who also acquire a full or partial guarantee of the projected benefits would be subject to an excise tax equal to 25 percent of the benefits that were guaranteed. Congress ought to stay out of the private marketplace. In truth, insurance of a tax result is merely the expression of an advisor's opinion that the transaction and its tax consequences are based on a correct interpretation of the law.

Fifth, the proposals would tax otherwise tax-exempt entities when they are parties to a corporate taxpayer's tax avoidance transaction. The law is already filled with rules to prevent arbitrage with exempt entities. Taxing hospitals, universities, and pension funds because some IRS agent found a tax shelter on the other side of one of their transactions is not a solution to any problems that may exist. The proposal targets exempt organizations, Native American tribal organizations, foreign persons, and domestic corporations with expiring net operating losses. The corporate parties would be jointly and severally liable for this tax if unpaid by the exempt taxpayer. In the case of a foreign person properly claiming the benefit of a treaty, or a Native American tribal organization, the tax on the income allocable to such persons in all cases would be collected from the corporate parties.

An additional provision would preclude taxpayers from taking tax positions inconsistent with the form of their transactions if a tax-indifferent party was involved in the transaction. A taxpayer could take an inconsistent position by disclosing the inconsistency. In effect, the rule is a reporting requirement masquerading as a deduction limitation.

The administration also proposes to make any tax deficiency greater than $10 million "substantial" for purpose of the tax code's substantial understatement penalty, rather than applying the existing test that such tax deficiency must exceed 10 percent of the taxpayer's liability for the year. There is absolutely no basis for the administration's assertion that large corporate taxpayers are "playing the audit lottery" because of the purportedly high threshold amount at which the substantial understatement penalty applies. A $10 million tax saving is the result of a $28 million deduction. Large corporations are subject to annual and continuous IRS audits by teams of IRS agents. Such a transaction is not entered into in the belief that the coordinated examination team will miss it.

Financial Products

Modify Rules for Debt-Financed Portfolio Stock.—The administration's proposal modifying the rules for debt-financed portfolio stock effectively would reduce the dividends-received deduction (DRD) for any corporation carrying debt—virtually all corporations—but would specifically target financial services companies, which tend to be more debt-financed. The Tax Council vigorously opposes this proposal as it has in the past opposed more straightforward proposed reductions in the DRD.

The purpose of the DRD is to eliminate or at least alleviate the impact of potential multiple layers of corporate tax. Under current law, the DRD is not permitted to the extent that relevant portfolio stock is debt financed. The administration's proposal would expand the DRD disallowance rule of current law for debt financed stock by assuming that all the debt of the corporation is allocated to the company's assets on a pro-rata basis. The proposal would therefore partially disallow the DRD for all corporations based on a pro-rata allocation of corporate debt.

The proposal would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more fair, rational, and simple tax system. Just as troubling is the notion that the DRD should be dramatically reduced for companies that are highly-leveraged. The proposal is particularly problematic for the securities industry, which maintains large quantities of equity investments in the ordinary course of its business operations. The Tax Council believes that, if anything, the multiple taxation of corporate earnings should be reduced rather than expanded, and that the administration's proposal clearly moves in the wrong direction.

Defer Interest Deduction and Original Issue Discount (OID) on Certain Convertible Debt.—The administration also proposes to defer deductions for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital. The Tax Council opposes this proposal because it is contrary to the sound tax policy that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that more than 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Re-characterizing these instruments as equity for tax purposes is fundamentally incorrect and would put American companies at a distinct disadvantage to their foreign competitors, which are not bound by such restrictions. Any abuse that the administration intends to abate should be targeted more narrowly.

Corporate Provisions

Require Accrual of Time Value Element on Forward Sale of Corporate Stock.—The proposal would require a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received as taxable interest income. This proposal would create a discontinuity in the tax treatment between a forward sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date. There is no apparent policy rationale for the proposal (e.g., there is not conversion of ordinary income to capital gain by virtue of a corporation entering into a forward contract to sell its own stock). Similarly, there is no economic gain to a corporation or its existing shareholders where the fair market value on the settlement date equals the contract price under the forward contract. For these reasons, Congress should reject this proposal.

Conform Control Test for Tax-Free Incorporations, Distributions, and Reorganizations.—The administration has proposed yet another corporate tax increase in the form of a proposal to alter the definition of "control," for purposes of determining the tax-free status of certain corporate reorganizations or restructurings. The proposal would substitute an "80-percent-by-vote-and-value" test for the current law test that looks to whether a corporate parent holds 80 percent of the voting stock and 80 percent of non-voting stock in a subsidiary.

The test of "control" is itself arbitrary, and there is little in the way of tax policy that argues for drawing the line by reference to vote and/or value. There is a concern, however, that the proposed amendment to the definition of "control" will unfairly penalize taxpayers, particularly where the amended definition would have a retroactive and (perhaps unintended) collateral impact on the ability of taxpayers to comply with other conditions to obtaining tax-free organization status. This might occur, for example, where a taxpayer would be prevented from coming into compliance with the new test due to the treatment in section 355(b)(2)(D) (which would prevent a spin-off from qualifying for tax-free treatment for five years from the date on which stock necessary to meet the new control test was purchased).

At a minimum, the administration's proposal should be targeted to deal with alleged "abuses," while allowing the other taxpayers adequate time to come into compliance with such a sweeping change in tax policy.

Tax Issuance of Tracking Stock.—Tracking stock is an economic interest that is intended to relate to, and track the economic performance of, one or more separate assets of the issuer. It gives its holder a right to share in the earnings or value of less than all of the corporate issuer's earnings or assets. Under the proposal, upon issuance of tracking stock, gain would be recognized in an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis. The stockholder's value still is subject to the claims of the creditors of the parent corporation, and has liquidation or redemption rights only in the parent company, not the tracked assets. The Tax Council opposes this attempt by the administration to impose a new tax on corporate transactions.

Modify Tax Treatment of Downstream Mergers.—Under this provision, where a target corporation does not satisfy the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to the acquiring corporation, and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor, the target corporation must recognize gain, but not loss, as if it distributed the acquiring corporation stock that it held immediately prior to the reorganization to its shareholders. The Tax Council opposes elimination of this longstanding and well-recognized ability to reorganize in a tax-free manner.

Deny Dividends-Received Deduction for Certain Preferred Stock.—Another proposal would deny the DRD for certain types of preferred stock, which the administration believes are more like debt than equity. Although concerned that dividend payments from such preferred stock more closely resemble interest payments than dividends, the proposal does not simultaneously propose to allow issuers of such securities to take interest expense deductions on such payments. Again, the administration violates sound tax policy and, in this proposal, would deny these instruments the tax benefits of both equity and debt.

The Tax Council opposes this. The United States is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased to the current 70 percent for less than 20 percent-owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the United States. To further decrease the DRD would be another move in the wrong direction.

Provisions Affecting Partners

Modify Basis Adjustment Rules for Partnership Distributions.—The administration proposes certain changes relating to the basis adjustment rules for partnership distributions. Under these rules, depreciable or amortizable property could never receive a step up on distribution to a partner in a liquidation; only capital assets could receive an increase. If the partner's basis in its partnership interest exceeds the basis of the property distributed to it (and no capital assets were distributed), the partner would recognize a long-term capital loss. The Tax Council is concerned that these proposals would require the shifting of basis from depreciable property to nondepreciable property. This is the wrong result.

Tax Accounting

Repeal Installment Method for Accrual-Basis Taxpayers.—The administration is asking Congress simply to eliminate the installment method for accrual-basis taxpayers. Installment sales treatment was studied and revised completely in 1980. At that time, the legitimate time value of money concerns of the administration were addressed. Under current law, if a corporation defers income recognition on an installment sale, it must make the Treasury whole by paying an interest charge on the deferred tax.

All that this proposal would do is accelerate actual tax cash flows to Treasury so it can spend the money sooner. Conceptually, the net present value of tax payments is not directly affected. For corporate taxpayers and the IRS, however, this provision actually would open an entirely new and difficult area of controversy. Corporate taxpayers typically elect installment sale treatment when the price of a transaction is contingent rather than dispute with the IRS over the value of the contingent price.

For example, a business unit may be sold for cash plus a percentage of the revenues for a stated number of years.

Deny Deduction for Punitive Damages.—Another provision that clearly lacks any policy foundation (and appears to be included purely for revenue-raising purposes) is the proposal to deny the deductibility of all future payments associated with "punitive" damages incurred in civil law suits. Civil punitive damages are a risk that virtually all companies are susceptible to in our present litigious society. They are often based on arbitrary and capricious jury awards rather than genuine violations of public policy and should be distinguished from the primarily criminal-type payments currently denied deductibility under the Code. Settlements would create a morass of new questions. Punitive damages generally are subject to tax in the hands of the recipient under the changes made to those rules in 1996. In effect, the administration seeks a windfall from punitive damage payments by denying their deduction while taxing their receipt. We adamantly oppose what would be an overreaching change in the tax law.

Repeal Lower-of-Cost-or-Market Inventory Accounting Method.—Certain taxpayers currently may determine their inventory values by applying the lower-of-cost-or-market method, or by writing down the cost of goods that are not salable at normal prices, or not usable because of damage or other causes. The administration is proposing to repeal these options and force taxpayers to recognize income from changing their method of accounting, on the specious grounds that writing inventory to market or writing down unusable or non-salable goods somehow "understates taxable income." Generally Accepted Accounting Principles (GAAP) require such write-downs in order to correctly state income. We strongly disagree with this unwarranted proposal. In addition, we believe that at the least, the lower of cost or market method should continue to be permissible when used for financial accounting purposes, to avoid the complexity of maintaining dual inventory accounting systems.

Changes Affecting Tax-Exempt Income

Disallow Interest on Debt Allocable to Tax-Exempt Obligations.—The administration seeks to effectively eliminate the "two-percent de minimis rule" of present law and disallow a portion of interest expense deductions for certain entities that earn tax-exempt interest. Although last year's proposal was designed to apply to corporations generally, this year's proposal would apply only to "financial intermediaries." Under the proposal, financial intermediaries that earn tax-exempt interest would lose a portion of their interest expense deduction based on the ratio of average daily holdings of municipals to average daily total assets.

In a related proposal, the administration seeks to increase from 15 percent to 25 percent the portion of a property casualty insurance company's tax-exempt income that is effectively subjected to tax through special proration rules. This would effectively eliminate any advantage of investment in tax-exempt bonds by property-casualty insurance companies.

The Tax Council strongly opposes the administration's proposals to increase the tax cost of state and municipal bond investments. Financial intermediaries and property casualty insurance companies play an important role in the markets for municipal leases, housing bonds, and student loan bonds. By eliminating this significant source of demand for municipal securities, the administration's proposal would force state and local governments to pay higher interest rates on the bonds they issue, significantly increasing their costs of capital. The cost of public facilities, such as school construction and housing projects, would be increased. This proposal is entirely inconsistent with tax incentive programs for some of the same state and local projects. At a time when the state and local governments are asked to do more, Congress should not make it more costly for them to achieve their goals.

Cost Recovery

Provides Consistent Amortization Periods for Intangibles.—Under current law, start-up and organizational expenditures are amortized at the election of the taxpayer over a period of not less than 60 months. Certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business or an activity for the production of income must be amortized over 15 years. Under the budget proposals, start-up and organizational expenditures would be amortized over a 15-year period. Small businesses would be allowed a $5,000 expensing of such costs. The Tax Council believes that the proper treatment of many start-up and organizational expenses in a neutral tax system would be expensing. Moving in the opposite direction, toward a longer artificial recovery period for such expenses, is simply increasing taxes on companies that are growing and expanding.

Insurance Provisions

Require Recapture of Policyholder Surplus Accounts (PSA).—Life insurance companies that were taxed under the old phase II positive regime of the Life Insurance Company Income Tax Act of 1959 would have their tax bills for 1959 through 1983 rewritten by the administration's proposal to tax policyholder surplus accounts. Companies would be required to include in their gross income over 10 years (one-tenth per year) the balances of the policyholder surplus accounts accumulated from 1959 through 1983. These accounts were part of a complex, Rube Goldberg set of provisions designed to balance the tax burdens of various segments of the insurance industry. Different companies benefited from different provisions, retroactively denying one set of companies their treatment is fundamentally unfair. Companies with policyholder surplus accounts never expected to pay tax on them. Congress should not change the rules at this late date.

Modify Rules for Capitalizing Policy Acquisition Costs of Life Insurance Companies.—This proposal would increase the percentage of life insurance and annuity premiums subject to DAC capitalization. House Ways and Means Committee Chairman Bill Archer, R-Texas, already has announced the DAC proposal will not be included in any package put forth by his committee. We agree with him. The current DAC rates are more than appropriate in light of the other rules that apply to life insurance companies that tend to overstate their income for tax purposes.

Modify Corporate-Owned Life Insurance (COLI) Rules.—The administration continues its four-year assault on COLI programs by proposing to repeal an exception to the present law proportionate interest disallowance rules for contracts on employees, officers or directors, other than 20 percent owners of the business that are the owners or beneficiaries of an annuity, endowment, or life insurance contract. This exception was designed to allow employers to create key-person life insurance programs, fund non-qualified deferred compensation and retiree health benefits, and meet other real business needs. The effect of this proposal would be to tax the inside build up in cash value life insurance whenever it is owned by a business that also has debt. Given the very long-term nature of life insurance investments, this rule would make insurance unattractive even to companies with no debt today, because they might need to borrow at some future date.

Exempt Organizations

Subject Investment Income of Trade Associations to Tax.—Under the proposal, trade associations including chambers of commerce, business leagues, and other similar not-for-profit organizations organized under Internal Revenue Code section 501(c)(6) generally would be subject to tax on their net investment income in excess of $10,000. The Tax Council opposes this $1.4 billion tax increase on trade associations. The current-law purpose of imposing unrelated business income tax on associations and other tax-exempt organizations is to prevent such organizations from competing unfairly against for-profit businesses. Subjecting trade association investment income to UBIT is counter to this legislative purpose. The administration proposal mischaracterizes the benefit that trade association members receive from such earnings. If these earnings on a trade association's assets did not exist, members of these associations would have to pay larger tax-deductible dues. There simply is not a tax abuse here. Congress should leave the present law rules as they are.

International

In its efforts to offset the cost of new government spending, the administration is unwise to target publicly held U.S. multinationals doing business overseas, and the Tax Council urges that its international tax increase proposals be rejected. The predominant reason businesses establish foreign operations is to serve local overseas markets so they can compete more efficiently. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the United States, along with improving the U.S. balance of payments. The creditability of foreign income taxes, which has existed in the Internal Revenue Code for over 70 years, is necessary to alleviate the double taxation of foreign income. Replacing these credits with less valuable deductions for any industry would greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals.

So that U.S. companies can better compete with foreign-based multinationals, the administration should instead do all it can to make the U.S. tax code more friendly and consistent with the administration's more enlightened trade policy. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income-based system, and arbitrarily denying a deduction for such expenses would only distort that system. Higher business taxes affect all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle-class workers.

The Tax Council believes that a fundamental reconsideration of the ways in which the United States taxes its corporate citizens when they operate abroad is long overdue. The result of that review should be to make U.S. companies more, not less, competitive. The administration has proposed a series of changes that move in the wrong direction.

Modify Treatment of Built-In Losses and Other Attribute Trafficking.—Under current law, a person who becomes subject to U.S. tax for the first time determines the basis of property and other tax attributes as though the person had always been subject to U.S. tax. This has been the rule since the beginning of the income tax. As a result, a taxpayer coming under the U.S. system may take advantage of built-in losses and would be taxed on built-in gains. The administration wants to replace the current rule with a "fresh start" that eliminates all tax attributes (including built-in losses and other items) and marks the taxpayer's assets to market when they become subject to U.S. tax. The proposal could benefit some taxpayers who would be entitled to a tax-free step-up in basis in their appreciated property at the time they become subject to U.S. tax. This far-reaching proposal would add much complexity to the tax laws.

The administration argues that although current rules limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain, similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax. The administration's extremely broad proposal is unnecessary. Existing anti-abuse provisions such as sections 269, 382, 446(b), and 482 address this issue. Congress should reject this ad hoc, yet very fundamental, change to our international tax rules.

Replace Sales-Source Rules with Activity-Based Rules.—The administration again proposes to replace the 50/50 source rule that determines the source of income from the manufacture of property in the United States and its sale outside the United States. An actual economic activity test rather than a fixed percentage would apply. This proposal is nothing short of a major tax on exports.

Exports are fundamental to our economic growth and our future standard of living. Over the past three years, exports have accounted for about one-third of total U.S. economic growth. The export source rule operates to encourage companies to produce their goods in their U.S. plants rather than in their foreign facilities. Repeal or cutbacks in the rule would reduce exports and jeopardize the addition of these high-paying jobs.

Since 1922, the 50/50 export source rule has been beneficial to companies that manufacture in the United States and export abroad because it increases the likelihood that double taxation of foreign income will be minimized by timely use of the foreign tax credit. Because the U.S. tax law restricts the ability of companies to get credit for the foreign taxes that they pay (e.g., through the interest and research and experimentation allocations), many multinational companies face double taxation on their overseas operations, i.e., taxation by both the U.S. and the foreign jurisdiction. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

The administration attempts to justify eliminating the 50/50 rule by arguing that it provides U.S. multinational exporters operating in high tax foreign countries a competitive advantage over U.S. exporters that conduct their business activities in the U.S. The administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries where we have treaties, thereby reducing the need for the export source rule. Both of these arguments are seriously flawed.

First, exporters with only domestic operations never incur foreign taxes and, thus, are not even subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on debt and R&D costs, because they do not have to allocate any of those expenses against foreign source income. Rather than creating a competitive advantage, the source rule simply levels the playing field for U.S.-based multinational exporters. Second, tax treaties cannot substitute for the export source rule. It is not income from export sales, but rather foreign earnings, that are the main cause of the double taxation described above. To the extent the treaty system lowers foreign taxation, it can help to alleviate the double tax problem, but only by treaty partners. These tend to be the most highly industrialized nations of the world. We have few treaties with most developing nations, which are the primary targets for our export growth in the future.

Foreign Oil and Gas Income Tax Credits.—The Tax Council's policy position on foreign source income is clear—"A full, effective foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate 'baskets,' should be eliminated."

The president's proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S.-based oil companies are already at a competitive disadvantage under current law since most of their foreign-based competitors pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation, which would severely hinder U.S. oil companies in the global oil and gas exploration, production, refining, and marketing arena.

Compliance

Increase Penalties for Failure to File Correct Information Returns.—The administration proposes to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

Other Provisions That Affect Receipts

Three Superfund Taxes.—The three taxes that fund the Superfund used to clean up abandoned hazardous waste sites (corporate environmental tax, petroleum excise tax, and chemical feed stock tax) and the Oil Spill Liability Trust Fund all expired December 31, 1995. The president's budget would reinstate the two excise taxes, as well as the 5 cents-per-barrel Oil Spill Tax, at their previous levels for the period after the date of enactment through September 30, 2009. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1998, and before January 1, 2010. Moreover, the funding cap for the Oil Spill Tax would be increased from the current $1 billion amount to the unreasonably high level of $5 billion.

These taxes, which were previously dedicated to Superfund and the Oil Spill Fund, would instead be used to generate revenue to swell the surplus or increase federal government spending. This use of taxes, when historically dedicated to funding specific programs, should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

Convert a Portion of the Excise Taxes Deposited in the Airport and Airway Trust Fund to Cost-Based User Fees.—The administration wants to restructure the Airport and Airway Trust Fund. The Tax Council has no opinion on those proposals. The administration also wants to lower air ticket taxes and in their place impose Federal Aviation Administration user fees. The ultimate result of these proposals is an additional $5.3 billion going to Washington. The Tax Council opposes increasing government revenues from the air transportation sector. The Airport and Airway Trust Fund is not spending what it has. Why is more needed? The assets in the trust fund are projected to grow from $12.3 billion in 1999 to $20.9 billion in 2004. It is hard to understand why we need a $5 billion cost increase to the traveling public.

CONCLUSION

The Tax Council strongly urges the administration to reconsider the tax policy behind many of the revenue-raising proposals in its FY 2000 budget. Congress, in considering the administration's proposals, should elevate sound and justifiable tax policy over mere revenue needs.

TELEPHONE & DATA SYSTEMS, INC.
MIDDLETON, WI 53562
March 23, 1999

A.L. Singleton
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Mr. Singleton, Ways and Means Members:

I am writing on behalf of Telephone & Data Systems, Inc. (TDS) to voice both our concern over the proposed "Tax Shelter" legislation now before your committee and our support for the permanent implementation of Internal Revenue Code (IRC) Section 127—the income exclusion for both graduate and undergraduate employer provided educational assistance payments. TDS is a telecommunications company with over 9,900 employees providing service to over 3,000,000 customers in 35 states.

TAX SHELTER PROPOSALS

These proposals seem to stem from the December 14, 1998 issue of Forbes in which the cover story labeled certain tax reducing transactions with movie ratings (i.e. PG–13, R and X) based upon their view of the relative degree of egregiousness. TDS also realizes the importance of effective and enforceable tax laws on the equitable administration of this country's revenue collection systems. It is certainly an honorable legislative objective to strive for such administration, and we appreciate your desire to correct "loopholes" in the application of the IRC. We maintain, however, that the already thin line between tax planning and "tax avoidance" will become even more subjective under these proposals. Further, these proposals indicate a preference toward interpretations of the intent of the law over the law itself. Where the letter of the law has been followed, it should be respected as a Constitutional right to apply the law, even if taxpayer favorable. In a 2nd Circuit Court Decision (1947), Judge Learned Hand clearly understood the concept when he stated;

> "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Nobody owes any public duty to pay more than the law demands. Taxes are enforced extractions and not voluntary contributions. To demand more in the name of morals is mere cant."

We know that it is easier to take a simple, blanket approach to a legislative objective than to craft more complex, specific provisions that attempt to take into account all current and possible fact patterns. Our concern is that the President's proposal would provide the IRS with a new weapon which, as currently crafted, would raise the risk of serious wounds being inflicted on innocent bystanders. The following transactions could now be considered "tax avoidance transactions" subject to disallowance:

- Investing in Municipal bonds rather than fully-taxable securities
- Charitable contributions—they have no pre-tax economics
- Donating appreciated property rather than cash to charity—the primary purpose is viewed as tax planning by those who benefit from it, but tax avoidance by those who do not.
- Choosing to sell a business' assets rather than its stock—generally the primary motivation is to minimize tax.

The IRS has already demonstrated that it will shamelessly exaggerate the application of an IRS favorable decision on specific facts.[1] In our opinion, the IRS has taken the INDOPCO decision and is moving down a continuum toward capitalization of virtually all salaries and marketing expenses because they provide some future benefit beyond the current year. The only deductible costs will be for unsuccessful efforts and employees who provide no benefits to the company—why employ them?

We recognize that it is difficult to be patient. Difficult to wait for the wheels of common law jurisprudence to turn out a sufficiently accurate and enveloping body

[1] INDOPCO, 503 U.S. 79 (1992)

of case law, such that "justice is done" to all parties. All of these things prompt you, as a body, to strike quickly and soundly. We urge you to take the more difficult path. To take the path of patience. To take the path of methodical judgment.

In addition, we have two technical concerns with the President's proposed Tax Shelter legislation that we hope you will consider. First, it unnecessarily duplicates existing law, and it will inappropriately subrogate the enacted language of the Internal Revenue Code beneath "legislative history." Second, we are bothered by the perpetual shift of authority, away from the courts and Congress and towards the IRS.

The President's proposals unnecessarily duplicate existing law in several key areas, two of which are "form vs. substance" and tax fraud.

Form vs. Substance:

> In the Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal (hereinafter, "the Description"), *Substance over Form Section*, the drafters characterize the "Danielson rule"[2] and the "strong proof" rule as set forth in Ullman[3] as providing "relatively high standards of proof" which a taxpayer must meet before being allowed to elevate the substance of a transaction over the form that the taxpayer selected for that transaction. This is a gross understatement of the impact these cases have on a taxpayer attempting to "overturn" the form of a transaction which he or she devised. In Danielson, the court provided that a taxpayer must show "proof which in an action between the parties...would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." Therefore, to prevail under the "Danielson rule" a taxpayer must not only be able to show that the form of the transaction was not the intended form but also that the parol evidence rules would allow the taxpayer to challenge the form of the transaction against the other party in a court of law. In short, this provides that the only time a taxpayer can advocate substance as controlling over form is when the binding form of the transaction is itself in substantial doubt.
>
> The Danielson court went on to find that "the "strong proof" rule [See Ullman above] would require that the taxpayer be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement." Therefore, even under the "strong proof" rule, the taxpayer will be held to the form of his or her transaction absent substantial doubt as to the form. This section of the Description also states that it is important to "impose restrictions on the taxpayer's ability to argue against the form it has chosen." It is our belief that court cases such as Danielson and its successors have already imposed such restrictions. Enacting any legislation that attempts to further confine taxpayers to the "bed that they have made" would serve no useful purpose.

Tax Fraud:

> In the Description, *Section on the Understatement Penalty*, the drafters discuss the President's proposed increase (from 20% to 40%) in the substantial understatement penalty. They also point out the "safe harbors" available to the taxpayer in order to avoid imposition of the "extra" 20%:

1) Disclosure of the "transaction" to the National Office within 30 days of filing the return

2) Attaching a statement of disclosure to the return, or

3) Providing adequate disclosure of the book to tax differences (M–1's) on the return.

> Ignoring the ambiguity of multiple court definitions of "adequate disclosure," it seems to us that any taxpayer not engaged in attempting to defraud the IRS will be exempt from the 20% "excess" penalty. After all, the only time its appears such a penalty could be imposed is when a taxpayer misrepresents book-to-tax adjustments that are material with an intent to deceive the IRS. There are already multitudes of penalties and punishments (some criminal) for this kind of behavior. It does not seem necessary to us to "arm" the IRS with another "weapon" sure to be threatened against

[2] See, Danielson v. Commissioner, 378 F.2d 771 (3d Cir. 1967) cert. denied, 389 U.S. 858 (1967)

[3] See, Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959)

all taxpayers but which could only be used on those already penalized by myriad other regulations.

The President's proposals inappropriately subrogate the enacted language of the IRC beneath "legislative history." In doing so, these proposals will not only make it more difficult and time-consuming for trial judges but it will also effectively turn over years of Common Law precedent.

In the Description, *Section on Tax Avoidance Transactions*, the drafters state that under the President's proposed expansion of IRC § 269, the Secretary will be able to "disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction." The Description continues by providing, by reference to the *Section on Understatement Penalties*, the definition of a "tax avoidance transaction";

> Any transaction in which the reasonably expected pre-tax profit...of the transaction is insignificant relative to the reasonably expected net tax benefits...of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

Our concern with this proposal lies in the definition of "improper." If enacted, this proposal would give the Secretary the authority to disallow the "tax benefits" of a transaction if the Secretary deemed the transaction merely "improper." This is not only a drastic change from the current law's standard but it puts the courts in a new predicament if the taxpayer challenges the Secretary's determination.

Current case law supports the Secretary's disallowance of tax benefits generated from transactions, the principle purpose of which is the avoidance of tax. Interpretation of this standard, as well as similar legislative breakwaters,[4] certainly requires a complex measurement of the pre-tax economics and tax benefits of the transaction, but is a measurement that is possible to make within the letter of the law. If the standard is changed from "principal purpose" to merely "improper," the courts, obviously, must look to what is proper and what is improper. Whenever the courts must look to proper and improper they must look to legislative intent. There becomes no path open to a court that does not lead down this treacherous and ambiguous slope of original legislative mindset. When Treasury and the IRS challenge a taxpayer's tax benefit as improper, a court will have no choice but to delve into the history of the section rather than interpreting it on its face. The language of a statute will cease to be decisive, even if unambiguous, as the propriety or impropriety judged by the historic intent and focus of Congress becomes the only relevant question.

Obviously, this would turn a large amount of case law on it's collective head. The current Common Law requirement is not to look to legislative history unless the statute is patently ambiguous. As the court stated in Pope v. Rollins Protective Services Co., 703 F.2d 197, 206 (5th Cir. 1983)[5]; "[i]t is axiomatic that where a statute is clear and unambiguous on its face, a court will not look to legislative history to alter the application of the statute except in rare and exceptional circumstances." Forcing a court to consistently weigh all "improper" benefit cases by this standard not only overrides centuries of stare decisis but also puts the intent of the lawmakers, as presumed by the judiciary, in higher regard than the plain face of the law itself. It is the legislature's responsibility to draft statutes that do not require this sort of "revisionism" by the judicial benches of this country. Accordingly, if there are specific provisions you wish to change, then change them, leaving not a legacy that needs IRS and judicial interpretation to decide propriety, but rather one that speaks loudly and independently.

As we have already alluded to, many of the President's proposals seem to give broad and unregulated authority to the IRS. This is particularly true in the areas of substantial underpayment penalty and denial of benefits associated with "tax avoidance transactions." It is generally unclear to us what would justify this broadened authority. It was not that long ago that your body had hearings to disclose and discuss abusive IRS practices; certainly increasing their already broad power without a corresponding increase in Congressional oversight will not prove worthwhile. As we have previously mentioned it also seems unlikely for this expansion

[4] Such as "primary" or "significant" purpose

[5] See also, e.g. *Dickerson v. New Banner Institute, Inc.*, 103 S.Ct. 986, 990, (1983); *North Dakota v. United States*, 103 S.Ct. 1095, 1103 (1983); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19, 100 S.Ct. 242, 246, 62 L.Ed.2d 146 (1979). "Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive." *Consumer Product Safety Comm'r v. GTE Sylvania, Inc.*, 447 U.S. 102, 108, 100 S.Ct. 2051, 2056, 64 L.Ed.2d 766 (1980). *Rubin v. United States*, 449 U.S. 424, 430, 101 S.Ct. 698, 701, 66 L.Ed.2d 633 (1981);

of IRS power to result in less litigation, as an IRS sword sharpened legislatively can only be dulled by repeated judicial admonition.

We acknowledged in our introduction the importance of this legislation. It is certainly good public policy to have a fair and rationale tax code. As in all things, fairness in the tax code is a balancing act and one must strive for equilibrium. Making the IRS, an enforcement agency and one party in an adversarial system, an omnipotent arbiter of your present intent does not seem likely to strike an appropriate balance between taxpayer and IRS. Take the difficult path now, craft your proposals wisely so that the judiciary can interpret the letter of the law, and the IRS can enforce it. Do not take the "low road" and plague the court system and "good faith" taxpayers with an over-armed, trigger happy, out of control IRS.

Educational Assistance Proposal

We are sure that you are aware of the positive impact that educational assistance, in any form, has on individuals, businesses and society at large. We at TDS also realize the importance of education in improving our employees' work performance and in expanding their horizons. TDS has a long-standing commitment to employee betterment and education on many levels, including a company-wide employee education policy that provides time off and full reimbursement for successfully completed courses regardless of the subject of study.

Presently, IRC Section 127's exclusion allows employee-students at the undergraduate level to reap the benefits of employer provided educational assistance without bearing the burden of increased Federal income taxes. In addition to legislatively solidifying this employee opportunity, it is TDS's position that you should extended this benefit to employees pursuing a graduate course of study. In order to maintain and enhance our position in an increasingly competitive marketplace we need our employees to continuously maintain and enhance their own professional competence. Often, this further education manifests itself in the form of a graduate academic environment because an undergraduate degree is already a prerequisite for many positions. We feel strongly that there should not be a distinction between IRC Section 127 "covered" and "non-covered" courses based on whether a course is undergraduate or graduate. This type of arbitrary line drawing only serves to apply Section 127 unfairly, excluding important and needed coursework simply because an individual has surpassed some minimum educational requirement.

It seems that everywhere one looks these days new educational opportunities and possibilities are being bantered about. Soon, you will have the ability to go beyond rhetoric and towards implementation, the ability to solidify and expand an educational program that will help current and future generations. We urge you to take this opportunity to provide America's employees with the educational opportunities they need to face the next millennia. Specifically, we request that you make the employer provided educational assistance income exclusion permanent and apply it to all workers who strive to improve themselves.

Sincerely,

ROSS J. MCVEY
Assistant Controller and Director—Tax

Statement of United States Telephone Association

The United States Telephone Association ("USTA") is pleased to have this opportunity to file a statement for the record in connection with the March 10, 1999 hearing held by the Committee on Ways & Means on the Administration's tax proposals. USTA is the primary trade association of local telephone companies serving more than 98 percent of the access lines in the United States and represents over 1100 members from the smallest of independents to the large regional companies.

We have carefully reviewed all of the tax proposals submitted as part of the Administration's budget package for their impact on our industry. However, the proposals we comment on in this submission are only those which would have the most significant impact on USTA members and the economic environment in which our industry operates.

1. Extension of the Research and Experimentation Tax Credit

We vigorously support the extension of this vital credit for another twelve months from July 1, 1999 to June 30, 2000, as called for in the Administration's budget. Although USTA would prefer a longer term extension, or, better yet, that the credit be made permanent, we believe that the credit provides an important incentive for U.S. companies to increase and expand the level of commitment to tomorrow's world of communication, and deserves to be extended.

As the information age continues to advance in both technology and reach, the credit becomes increasingly important. It provides a real incentive for U.S. companies in our rapidly changing industry to increase and expand the level of commitment to the next generation of communications. The extension of the research and experimentation credit is one of the intelligent choices Congress can make to insure that the U.S. remains the world's leader in communications. Indeed, Congress should seriously consider making this credit a permanent feature of the tax code and remove any doubt about its future so that technology-intensive businesses, such as USTA's members, can plan with confidence the shape of tomorrow's communications revolution.

2. Extend the Exclusion for Employer-Provided Educational Assistance

As part of its education initiatives, the Administration has proposed an eighteen month extension of the current law exclusion from an employee's income for amounts paid (up to $5,250 per year) by employers for undergraduate courses beginning before January 1, 2002. In addition, the exclusion would be reinstated for expenses paid for graduate education, effective for courses beginning after June 30, 1999 and before January 1, 2002. USTA strongly supports these initiatives.

The exclusion is one of the most useful and practical means of encouraging educational opportunity and to react to the changing needs of the workplace. While USTA would prefer a permanent extension of the exclusion, the eighteen month extension, as well as the application to graduate courses, is well-received in the telecommunications industry where many employers offer educational assistance. We urge Congress to avoid any disruption in the tax treatment of these expenses (as has occurred in the past) by swiftly enacting these proposals.

3. Corporate Tax Shelter Provisions

USTA urges Congress to carefully review the tax shelter proposals which the Administration has authored. Abuse of the tax system should not be tolerated since it results in higher taxes for those who dutifully comply, and encourages disrespect among taxpayers generally. However, there is a careful line which should be drawn between legitimate tax planning in the course of business transactions that are often quite complicated, and outright manipulation of the system solely for tax avoidance purposes.

The Administration has proposed both specific and broad measures to combat corporate tax shelters. With regard to specific provisions that deal with clearly described transactions or accounting practices, Congress should evaluate these as it traditionally has. However, with regard to broader proposals, such as the Administration's proposed definitional changes in what constitutes a "tax shelter," "tax avoidance transaction," "tax benefit," etc. and its proposal to impose substantially increased penalties, its disallowance of deductions for tax advice in certain situations, etc., USTA urges real caution. A great deal of effort should be devoted to evaluating these proposals to determine if they are too broadly crafted, imprecise and/or provide the IRS with too broad a grant of power to determine violations.

4. Reimpose Superfund Corporate Environmental Tax

The Administration's proposal would reinstate, for taxable years beginning after December 31, 1998 and before January 1, 2010, a corporate environmental tax imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded $2 million. USTA, while clearly in favor of environmental programs benefiting society, opposes the reinstatement of the Superfund tax in this manner at this time. Superfund currently faces no budgetary crisis, and, as the Chairman of the Committee on Ways and Means has noted, programmatic reform must take place prior to reinstating Superfund taxes that have expired. USTA supports this concept. In addition, if it is deemed necessary to reimpose this tax on corporations, USTA would strongly support a simplified calculation of alternative minimum taxable income for purposes of computing the Superfund Corporate Environmental tax.

5. Monthly Deposit Requirement for FUTA

USTA opposes the Administration's proposal to increase the frequency of FUTA and state unemployment insurance deposits from quarterly to monthly if the employer's tax liability in the prior year was $1,100 or more. This proposal would triple the number of required submissions and attendant paperwork, greatly increasing the already substantial FUTA administrative costs of employers. The one-time revenue gain to the federal treasury will more than be offset in the future by the real additional long-term administrative costs to the IRS from more-frequent FUTA tax collection. The federal government should not penalize those businesses that are not delinquent in making the required payments by imposing more frequent collections. Rather, means should be identified to enforce the obligations of those who have not made the required payments.

6. Subject Investment Income of Trade Associations to Tax

USTA joins with its sister trade and industry associations in opposing the Administration's proposal to tax net investment income in excess of $10,000.

The Administration's rationale for its proposal seemingly ignores the purpose of 501(c) (6) organizations that use investment income for the betterment of their memberships. The Administration appears to premise its proposal on the potential for dues reductions for members through the use of tax-exempt income. Although it has never been questioned that proceeds from Association investments might be appropriately used for such a purpose, even if investment income is used to reduce member dues payments there will be a resulting reduction in deductions taken for dues not paid. To suggest, as the Administration does, that the production of investment income in trade associations is merely a tool by which taxable member organizations receive the timing benefits of a tax deduction before making deductible dues payments seriously misunderstands the operation of most such associations. USTA, like many other industry organizations, uses its investment income for a variety of beneficial purposes—all related to the operation of the Association and its exempt purposes.

The Administration's proposal is an unnecessary and misinformed effort to produce revenue, and should not be adopted.

7. Estate and Gift Taxation

USTA supports efforts aimed at reducing estate taxes, particularly for small, family owned and operated businesses. Estate and gift taxes make it more difficult to maintain family ownership and control, encourage burdensome spending on strategies to deal with such taxes, and can cause unwanted and unwise transfers of ownership after years of dedicated stewardship.

Unfortunately, not one of the Administration's 1999 proposals in this area is designed to reduce such taxes. USTA urges Congress to work towards the reduction of estate taxes, not their enhancement.

Statement of LaBrenda Garrett-Nelson and Mark Weinberger, on behalf of Washington Counsel, P.C., Attorneys-at-Law

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy issues.

Introduction

At a time when the Administration and the Congressional Budget Office are predicting an "on budget" surplus, Treasury has proposed yet another corporate tax increase in the form of a proposal to tax the issuance of "tracking stock." In effect, this proposal would increase the cost of capital to corporations by inhibiting the use of "tracking stock" as a financing option. Apart from proposing a new tax and granting broad regulatory authority to Treasury, the Administration's proposal fails to offer any tax policy reason for the change. Moreover, it is not at all clear that the issuance of tracking stock is an appropriate time to impose a tax, because there is no bail out of corporate earnings. For these and other reasons set forth below, the "tracking stock" proposal should be rejected.

Summary Of The Administration's "Tracking Stock" Proposal

The Administration's proposal would impose a new tax "upon issuance of tracking stock or a recapitalization of stock or securities into tracking stock." The tax would be based on a hypothetical "gain," determined by reference to "an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis." For purposes of this rule, "tracking stock" would be defined as stock that relates to, and tracks the economic performance of, less than all of the assets of the issuing corporation," if either (1) dividends are "directly or indirectly determined by reference to the value or performance of the tracked entity or assets," or (2) liquidation rights are "directly or indirectly determined by reference to the tracked entity or assets." "General principles of law would continue to apply to determine whether tracking stock is stock of the issuer or not stock of the issuer." Treasury would be authorized to prescribe regulations treating "tracking stock as nonstock (e.g., debt, a notional principal contract, etc.) or as stock of another entity as appropriate to prevent tax avoidance, and to provide for increased basis in the tracked assets as a result of gain recognized." The "issuance of tracking stock [would] not result in another class of the stock of the corporation becoming tracking stock if the dividend and liquidation rights of such other class are determined by reference to the corporation's general assets, even though limited by the rights attributable to the tracking stock." The provision would be effective for "tracking stock" issued on or after the date of enactment.

I. The Administration's Proposal Would Inhibit The Use Of A Valuable Corporate Financing Tool

Over the last 15 years, corporations have utilized "tracking stock" as a vehicle for raising capital and to meet a variety of non-tax, business needs. By limiting the financing options of U.S. corporations, the Administration's "tracking stock" proposal would impinge on the ability of corporations to raise low-cost capital in an efficient manner, and thereby have an adverse impact on economic growth, job creation, and the international competitiveness of U.S. businesses. The "tracking stock" proposal would also inhibit the ability of businesses to use "tracking stock" in several other beneficial situations, such as issuing the stock in employee incentive programs to attract and retain key employees and to better align management and shareholders interests.

A. Corporations Have Issued Tracking Stock For a Variety of Business Reasons

"Tracking stock" is issued by corporations that have multiple lines of business that the marketplace would value at different prices if each line of business were held by a separate corporation.. By issuing "tracking stock," a corporation can raise capital in a manner that improves the attractiveness of the issuer's stock to the public. The valuation of the entire enterprise increases, because "tracking stock" provides a mechanism for "tracking" the performance of individual businesses. There is, however, no actual separation of a tracked subsidiary or other asset. The corporate issuer continues to benefit from operating efficiencies that would be lost if different lines of business became independent. These efficiencies include economies of scale, sharing of administrative costs, and reduced borrowing rates based on the issuing corporation's overall credit rating. Thus, it is clear that corporations issue "tracking stock" for the business purpose of obtaining the highest value for the separate tracked business, while maintaining legal ownership and other operating synergies.

Tracking stock has also been used as "acquisition currency," issued to the former shareholders of an acquired subsidiary. A commonly cited example of the use of tracking stock as acquisition currency is GM's 1984 acquisition of EDS, in which GM Class E tracking stock was issued. In this context, tracking stock can serve a variety of business purposes, including (for example) providing an incentive for managers of a newly acquired business to remain with the company; or allowing former shareholders of the acquired business to continue participation in the business's growth.

As another example, tracking stock has been issued in wholly internal transactions. These internal issuances are undertaken to maintain separate business reporting for rating agency and SEC regulatory accounting purposes, while achieving local tax consolidation in various foreign countries.

B. The Essential Elements of "Tracking Stock" Are Consistent With the Form of the Transaction as Stock of The Issuer

Typically, "tracking stock" is issued as a class of common stock, the return on which is determined by reference to less than all of the issuer's assets. The "tracked" asset can take a variety of forms (e.g., a line of business, a separate subsidiary, or a specified percentage of a separable business). Significantly, there is no legal separation of corporate assets, and thus an investor's return is subject to the economic risks of the issuer's entire operation:

(1) Voting rights of a holder of tracking stock are in the issuer (not, for example, a "tracked" subsidiary);

(2) Dividend Rights, although based on the earnings of a tracked subsidiary or other asset, are subject to whether the parent/issuer's board of directors declares a dividend, as well as state law limitations on the parent/issuer's ability to pay (without regard to a "tracked" subsidiary's ability to pay).

(3) Liquidation Rights might be determined by reference to the value of tracked assets, but investors in tracking stock have no special right to those assets; rather they are entitled to share in all of the issuer's assets on a pro rata basis.

II. The Administration's Tracking Stock Proposal Presents Serious Tax Policy Concerns, in Addition to Unresolved Technical Issues

A. Unjustified and Radical Departure From the Normal Treatment of a Stock Issuance

Section 1032[1] provides tax-free treatment to the corporation in every case where a corporation issues its own stock, without regard to whether the issuance constitutes a tax-free exchange or a transaction in which gain or loss is recognized to the recipient of the stock. The Administration's proposal represents a radical departure from this established tax principle, and inappropriately relies on the typical features of tracking stock to justify the result.

The typical dividend, voting, and liquidation rights of tracking stock supports the conclusion that such stock is stock of the issuing corporation, particularly where the holder's right to dividends are left to the discretion of the issuer's board of directors, voting rights are in the issuer, and the holder stands behind creditors with no right to specific assets on liquidation.

Lastly, it should be said that it is simply unsound tax policy to write ad hoc rules, without regard to whether those rules have any basis in established tax law principles. One sure result of this approach is the creation of discontinuities in the law. For example, if "tracking stock" is singled out for a tax increase, taxpayers issuing tracking stock would be inequitably disadvantaged as compared to other taxpayers using substantially similar economic arrangements. What then would the Administration have accomplished apart from interfering with the capital markets by increasing the costs associated with issuances of tracking stock?

B. Imposition of a Preemptive Tax Without Any Showing of Abuse or Other Tax Policy Concern

As observed by the staff of the Joint Committee on Taxation, "tracking stock may be structured in any number of ways that could result in holders having very different types of rights with respect to tracked assets."[2] Indeed, the Administration itself characterized the present law classification as a determination that "is dependent upon the correlation to the underlying tracked assets." Nevertheless, the Administration proposes to impose a tax upon every issuance of tracking stock, even if there are no tax policy concerns.

For example, the Administration has failed to explain why a tax should be imposed where tracking stock is issued "internally"—wholly among members of an affiliated group of corporations—for the purpose of facilitating separate financial reporting or other non-U.S. tax, business goals. There is no apparent tax policy concern where tracking stock is issued in a non-divisive transaction, particularly in the case of an internal issuance. As another example, it is not clear why a tax should be imposed where tracking stock is issued to provide an incentive under an employee compensation plan, as a tool for linking compensation to the performance of a business under the recipient's management.

C. Technical Issues

Circular Definition Of Tracking Stock.—The Administration recognizes that the proposed definition of "tracking stock" could include stock that has no tracking-stock features. For example, consider a corporation with one class of common stock outstanding, which then issues a new class of tracking stock, dividends on which are based on the operating results of one of the corporation's two subsidiaries. In such a case, by definition, the pre-existing common will constitute "stock that relates to

[1] Except as provided, references to "sections" are to the Internal Revenue Code of 1986, as amended (referred to herein as the "Code").

[2] Description Of Revenue Provision Contained In The President's Fiscal Year 2000 Budget Proposal, prepared by the staff of the Joint committee on Taxation (February 22, 1999) (referred to as "JCS–1–99") at page 224.

. . . less than all of the assets of the issuing corporation;" similarly, dividends on the common will essentially track the results of the other subsidiary.

The proposal seeks to address the circularity in the definition of tracking stock by including the statement that the "issuance of tracking stock will not result in another class of the stock of the corporation becoming tracking stock if the dividend and liquidation rights of such other class are determined by reference to the corporation's general assets, even though limited by the rights attributable to the tracking stock." The proposal fails, however, to describe the mechanics of this "savings" clause.

Absence of Guidance Regarding Collateral Consequences Resulting From Potential Application of the Definition of "Tracking Stock" to Instruments That Resemble Tracking Stock. Reportedly, Treasury is examining the use of "exchangeable shares" (which can be thought of as "reverse tracking stock," in that the shareholder's return is based on the results of the corporate parent of the issuing corporation). Exchangeable shares" have been used in acquisitions in which U.S. companies have acquired Canadian subsidiaries.[3] Very generally, these acquisitions take the form of recapitalizations in which shareholders of the acquired company exchange their stock for exchangeable shares, with the U.S. acquirer holding the balance of the company's outstanding stock. Among the many issues presented if the Administration's tracking stock proposal is intended to sweep in securities such as exchangeable shares, is whether dividend payments to Canadian shareholders in these cases is subject to U.S. withholding (on the grounds that the exchangeable shares are stock of the "tracked" U.S. acquirer).

Failure To Provide Any Substantive Guidance. Apart from the imposition of a new tax, the Administration's proposal fails to provide any substantive guidance on the treatment of tracking stock under the Code. Although the treatment of tracking stock as stock of the issuer/parent is characterized as problematic, the proposal includes the statement that "[g]eneral principles of law would continue to apply to determine whether tracking stock is stock of the issuer or not stock of the issuer." Similarly, rather than providing operating rules to deal with identified issues, the Administration proposes to grant new and exceedingly broad regulatory authority for Treasury to prescribe rules treating tracking stock as nonstock, etc. Presumably, regulatory guidance would be applied prospectively; however, it is not at all clear whether Treasury contemplates a grant of authority to recast a transaction on a retroactive basis.

Unprecedented Basis Adjustment For Tracked Assets. The absence of careful analysis is highlighted by the Administration's suggestion that regulations could provide for increases of "inside" basis as the result of gain recognition. As the staff of the Joint Committee on Taxation has pointed out, however, "present law generally does not increase the basis of assets as a result of gain recognition on the distribution or sale of stock, unless an election is made under section 338" (relating to stock sales treated as deemed asset sales). Thus, there is uncertainty regarding the circumstances (if any) in which Treasury would exercise regulatory authority to increase basis.[4]

Uncertainty Regarding The Identity Of The Taxpayer. The Administration's proposal does not expressly state that the tax would be imposed on the issuing corporation (as opposed to a recipient of tracking stock). The imposition of tax on a recipient would make for incongruous results; particularly, for example, where the recipient receives the stock in exchange for cash and realizes no economic gain.

Tax Consequences of After-acquired Shares. The proposal would tax an issuance of tracking stock only to the extent that there is a gain measured by reference to the difference between the tracked asset's value and basis. Consider, however, a hypothetical case where there is no gain on the original issuance of a tracking stock (e.g., because the tracked asset is either a recently purchased business or stock with respect to which a section 338 election was made to step up the basis). Presumably, no tax would be imposed when the tracking stock is first issued. What if additional appreciated property is contributed three years later, in exchange for shares out of the same issue of tracking stock. Would all of the tracked assets be marked to market because the additional shares are tied to the entire (fungible) pool of tracked assets?

Characterization of the Deemed Taxable Event For Purposes of Other Code Sections. Little thought seems to have been given to the effect of the gain recognition

[3] See IRS Officials Consider Cross-border Exchangeable Stock Deals," Tax Notes Today (January 29, 1999)

[4] The Tax Reform Act of 1986 provided similar authority in section 336(e), relating to certain stock sales and distributions treated as asset transfers, but Treasury has never issued regulations.

event. Would it constitute a deemed sale of the tracked assets? If so, would the sale be viewed as a transaction with a related person or an unrelated person? Where a controlled foreign corporation is involved, the answers to these questions could affect whether the deemed gain is currently taxable under subpart F of the Code.

III. THE ADMINISTRATION HAS FAILED TO ESTABLISH A REASON TO SINGLE OUT TRACKING STOCK FOR CONGRESSIONAL ACTION

The Administration has failed to set forth a basis for either legislative action or the delegation of additional regulatory authority to Treasury. Tracking stock is not a new concept in the tax law. Even under the Administration's proposal, general principles would continue to apply to require that the terms of tracking stock be consistent with treatment of such stock as stock of the issuer.[5] Moreover, the enactment of the proposal would effectively put an end to the market for tracking stock, and thus little if any revenue would be raised.

A. Over Fifty Years of Tax Law Contradicts the Administration's Statement that "Tracking Stock is . . . Outside the Contemplation of Subchapter C and Other Sections of the . . . Code."

The stated rationale for the Administration's proposal begins with the bald conclusion that the "use of tracking stock is clearly outside the contemplation of subchapter C and others sections of the . . . Code." On the other hand, the Administration proposes to rely on "general principles of tax law" to resolve the rather fundamental issue regarding whether tracking stock is stock in the issuing corporation. It is quite clear, that present law is adequate to the task, particularly in view of the existence of case law that pre-dates the Internal Revenue Code of 1954.

Judicial Authority Relating to Tracking Stock Dates Back Fifty Years. As early as 1947, the U.S. Tax Court had occasion to consider the federal income tax consequences of the issuance of tracking stock in the case of Union Trusteed Funds, Inc. v. Commissioner.[6] That case involved a regulated investment company ("RIC") organized as a single corporation with several series of stock, each of which series represented an interest in the income and assets of a particular fund. Union Trusteed Funds held that the RIC would be treated as a single corporation.

Again, in 1965, the Ninth Circuit Court of Appeals reviewed a case where a corporation issued a new class of nonvoting preferred stock to new shareholders, in exchange for funds that the corporation used to establish a new line of business.[7] After a six-year period, if the new line of business was terminated or the preferred shareholders sold their stock, the corporation was obligated to redeem the preferred stock by the distribution of 90 percent of the assets in the new line of business. Here, again, notwithstanding the liquidation preference of the preferred stock, the court upheld the treatment of the corporation as a single company.

Similarly, the Congress has Dealt With Tracking Stock, When Deemed Appropriate in View of the Particular Purpose of Specific Tax Provisions. The Congress has taken account of the existence of tracking stock, as appropriate for purposes of particular tax provisions. For example, in 1986 the Congress reversed the result in the Union Trusteed Funds case (described above), by adding section 861(h) and thereby providing specifically for the separate application of the RIC qualification tests to each series in a series fund, based on the rationale that each such series functions as a separate RIC.[8] Significantly, the drafters of the 1986 RIC change did not appear to view the law as unsettled with respect to a series fund organized as a corporation. Rather, the amendment was enacted to resolve discontinuities that resulted where a series funds was organized as a single business trust (the treatment of which was uncertain).[9]

As another example, in the original enactment of the Passive Foreign Investment Company ("PFIC") regime, the Congress anticipated the possibility that tracking

[5] To date, however, the Administration has all but abdicated its authority to address tracking stock under current law. See Rev. Proc. 99–3, 1999–1 I.R.B. 109, sec. 3.01(44) (stating that the Internal Revenue ("IRS") will not issue rulings regarding the classification of tracking stock). But see Treas. reg. sec. 1.367(b)–4 (1998 regulations in which the IRS did address the treatment of stock that entitles the holder to participate disproportionately in the earnings generated by particular assets, in the context of prescribing circumstances in which gain will be triggered on the exchange of stock in foreign corporations).

[6] 8 T.C. 1133 (1947), acq. 1947–2 C.B. 4.

[7] Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965).

[8] General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation (May 4, 1987) at page 377.

[9] Id. At 376 (describing the need to clarify the treatment of a series fund organized as a business trust).

stock might be used to circumvent those rules, and thus included regulatory authority to treat "separate classes of stock . . . in a corporation . . . as interests in separate corporations."[10] Interestingly, the Congress did not suggest that all tracking stock should be so treated, thus allowing for circumstances in which the form of an issuance of tracking stock should be respected.

More recently, in 1990, the Congress specifically addressed a tracking stock issue in the legislative history of Section 355(d), a provision added to deny tax-free treatment to a "disguised sale" of a subsidiary. Very generally, section 355(d) triggers a tax on the distributing corporation in a divisive reorganization where 50 percent or more of the corporation's stock was acquired by purchase during the preceding five years. In measuring the five-year window, section 355(d)(6) reduces the holding period for stock for any period during which the holder's risk of loss is substantially diminished by any device or transaction. In this regard, the Conference Report on the 1990 legislation specifically cites the use of "so-called 'tracking stock' that grants particular rights to the holder or the issuer with respect to the earnings, assets, or other attributes of less than all the activities of a corporation or any of its subsidiaries."[11]

B. Treasury Has Sufficient Authority Under Present Law To Address Tracking Stock

As detailed below, the Administration's request for expanded regulatory authority should be rejected because current law already provides sufficient tools for Treasury to deal with the tracking-stock issues identified as "reasons for change."

The General Utilities Issue. The Administration avers that the treatment of tracking stock as stock of the issuer allows a corporation to "sell an economic interest in a subsidiary without recognizing any gain." This, the Administration suggests, is inconsistent with the 1986 legislation that reversed the General Utilities rule, so called after the case that provided an exception for liquidating distributions to the rule imposing two levels of tax on corporate earnings.

In the first instance, the Code does not impose a tax in every case where a corporation sells an economic interest in a subsidiary-the tax consequences depend on the nature of the "economic interest" (e.g., the sale of an option to buy stock in a subsidiary generally is treated as an open transaction until the option is exercised or expires, although the existence of such an option could have consequences under provisions such as constructive ownership rules). Moreover, the Administration's proposal does not even purport to resolve the General Utilities issue. In any event, some would argue that Section 337(d) already provides the Administration with ample authority to prevent the circumvention of General Utilities repeal.[12]

Inclusion of Tracked Subsidiary in a Consolidated Group. The Administration cites the fact that a subsidiary may remain a member of the parent's consolidated group after the issuance of tracking stock, as if this result is bad per se. It is not immediately clear why the issuance of subsidiary tracking stock should result in deconsolidation, as long as the parent corporation retains the 80-percent-of-vote-and value level of control prescribed by section 1504. In any case, similar to Treasury's existing authority to deal with General Utilities, Section 1504 already grants regulatory authority for Treasury to prescribe rules necessary or appropriate to carry out the purposes of the statutory definition of an affiliated group.

Tax-free Distribution of Tracking Stock. The Administration's "reasons for change" also notes the concern that "a distribution of the shares is tax-free to the shareholders and to the issuer, and the issuer can achieve separation from the tracked assets or subsidiary without satisfying the strict requirements for tax-free distribution." This statement assumes without analysis, that tracking stock effects a true separation in all cases. To the contrary, even where the terms of the tracking stock contemplates the payment of dividends based on the tracked assets,[13] the holder still participates in the economic benefits and burdens of the issuer as a whole. Thus, the insolvency of the issuer/parent would preclude the payment of dividends and

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[10] General Explanation of the Tax Reform Act of 1986 at page 1032 (positing that, without this regulatory authority, a foreign corporation engaged in an active business, which would not be a PFIC, could issue a separate class of stock and use the proceeds to invest in a PFIC or to invest directly in passive assets).

[11] H.R. Conf. Rep. No. 5835 p. 87.

[12] Indeed, a senior Treasury official was reported to have announced that Treasury would exercise its section 337(d) authority to prevent the use of tracking stock (presumably, to address abusive situations where general principles of law would be violated) "to sell a business without triggering...a tax." Tax Notes Today (March 20, 1989).

[13] As the staff of the Joint Committee on Taxation observed, "holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends." JCS–1–99 at page 224.

render subsidiary tracking stock worthless, without regard to the stand-alone value of the tracked subsidiary.

Consistent with the theory that underlies the tax-free treatment of stock dividends and reorganizations, the issuance of tracking stock is not an appropriate time to impose a tax, to the extent that a taxpayer's investment remains in corporate solution, and the stock represents merely a new form of participation in a continuing enterprise.[14] Nevertheless, the Administration's proposal would trigger a tax on the issuance of tracking stock, even in a case where a distribution of the tracked subsidiary would satisfy "the strict requirements for tax-free distribution."

Additionally, even where the correlation between the tracking stock and a tracked subsidiary is such that there is a separation in "substance," Treasury's existing authority under section 337(d) (the General Utilities anti-abuse rule) would be available. In any event, it should also be noted that the issuer of tracking stock remains liable for any tax attributable to appreciation in the tracked assets, thus preserving two levels of tax.

C. It is Questionable Whether the Administration's Proposal Would Increase Tax Revenues

It is arguable that the use of tracking stock increases tax revenues. This view is based on the availability of financing options such as the issuance of debt, an alternative that would generate interest deductions and thereby eliminate tax on corporate earnings. By comparison, the issuance of tracking stock does not reduce a corporation's tax liability because dividends are paid out of after-tax income. In any case, one likely consequence of the Administration's proposal is that few (if any) corporations will issue tracking stock.

CONCLUSION

In curtailing the availability of financing options, the Administration's tracking stock proposal would force companies to abandon an efficient means of raising low-cost capital, and to turn instead to higher-cost alternatives. This runs counter to the long-term interests of the American economy. Moreover, there are numerous unanswered questions regarding the applicability and administrability of the tracking stock proposal. For these reasons, the Congress should reject the Administration's tracking stock proposal.

[14] See generally Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, par. 12.01[3] regarding the theory underlying tax-free treatment